Corporate governance and firm performance of private SMEs in Estonia

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# Table of contents

INTRODUCTION ..........................................................................................................................3
List of original studies ..................................................................................................................3
**Motivation and novelty of the research** ...................................................................................4
Research objectives and tasks .....................................................................................................7
Research design and summary of Studies .................................................................................7
Contribution of individual authors ............................................................................................11
Acknowledgements ....................................................................................................................11

1. **LITERATURE REVIEW AND RESEARCH QUESTIONS** ..............................................12
   1.1. Conceptual framework of corporate governance: key definitions and linkages .......12
   1.2. Theories of corporate governance ..............................................................................15
   1.3. Private SME governance in Estonian institutional environment .............................17
   1.4. Performance domains .................................................................................................19
   1.5. Summary of literature review, research gaps and research questions of the thesis .20

2. **EMPIRICAL STUDIES** ........................................................................................................23

3. **DISCUSSION OF RESULTS AND CONCLUSIONS** ...................................................24
   3.1. Discussion of research questions .................................................................................24
   3.2. Practical implications .....................................................................................................30
   3.3. Limitations and avenues for further research .............................................................31

REFERENCES ..............................................................................................................................33
INTRODUCTION

List of original studies


Motivation and novelty of the research

Corporate governance has been practiced for as long as corporate entities have existed, yet the academic research of the subject is only about 40 years old. The phrase “corporate governance” was rarely used until 1980s, which makes it relatively new discipline, at least compared to the study of management for example. While there was a substantial proliferation of management thought throughout the 20th century with development of variety of theories, frameworks and models in all fields of management (finance, marketing, operations etc.), the aspects of corporate governance caught attention only in the last couple of decades of the century. The field has now expanded, yet much is still to be learned. The 21st century promises to be the century of corporate governance as the focus shifts to the legitimacy and the effectiveness of corporate entities around the world (Tricker, 2018).

Majority of corporate governance research has been conducted on large public companies in large markets, especially in Anglo-American countries, leaving other contexts relatively under-explored. However, the findings from the afore-mentioned settings are not necessarily applicable to other contexts, as the circumstances are different (Denis & McConnell, 2003; Huse, 2007; Aguilera & Jackson, 2010; Clarke, 2016, Armitage et al., 2017). For example, Anglo-American countries are characterized by strong property rights, well developed financial markets, rich information flow and relatively efficient formal and informal institutions, such as courts or professional norms (Roe, 2004; Kumar & Zattoni, 2019), which is not always the case in other countries. These external governance mechanisms already provide certain level of control function for shareholders in these developed markets. Lack or ineffectiveness of these external institutions in some other markets requires compensatory internal governance mechanisms, such as supervisory board’s monitoring role or other control systems (Douma et al., 2006). Also, Anglo-American countries are characterized by dispersed ownership while in other regions, for example Continental Europe, Japan or emerging economies firms tend to have concentrated ownership (La Porta et al., 1999; Yoshikawa et al., 2014: Armitage et al., 2017). This renders different types of issues to be dealt with corporate governance.

Furthermore, previous research has predominantly focused on agency problems and keeping management accountable, i.e. it has dealt mostly with compliance and minimizing downside risks of firms. However, corporate governance can also help firms unlock the upside potential and perform better as shown by a respective growing research domain (e.g. Uhlaner et al., 2007; Aguilera et al., 2016). Such broader view on the goals of corporate governance follows the wider evolution of economic and societal transformations (Filatotchev et al., 2020), such as the rising importance of incorporating stakeholder and corporate social responsibility views into the corporate purpose (e.g. Freeman, 1984; Brink, 2010; García-Castro & Aguilera, 2015; Barney, 2018). A remarkable illustration for this movement is the redefinition of corporate purpose in stakeholder terms by the Business Roundtable, an association of chief executive officers of leading companies in the U.S. (Harrison et al., 2020). These leading firms now “commit to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders” (Business Roundtable, 2019). In summary, research in these underexplored institutional contexts and broader views on corporate governance is ongoing but more work is being called for by several authors (e.g. Uhlaner et al., 2007; Brunninge et al., 2007; Chen et al., 2014, Neckebrouck et al., 2019).

This thesis focuses on corporate governance in the context of private small and medium-sized enterprises (SMEs) domiciled in Estonia, and deals with governance from a broader perspective, i.e. it focuses not only downside risks but also on value creation side of governance. The study is motivated by various aspects as explained below.
During recent years there have been signs of stagnation and lack of new ideas in Estonian economy as shown by several studies regarding management practices mandated by Enterprise Estonia (Eesti juhtimisvaldkonna uuring, 2011; 2015). Both studies concluded with several points of criticism towards Estonian owners and managers: lack of ambition, lack of cooperation between owners and managers, unwarranted satisfaction with the status quo, and many others, i.e. topics relevant for corporate governance. It seems that there is a low awareness of how corporate governance could be used to push Estonian firms to the next level, which calls for more systematic study and discussion of the topic, specifically in the context applicable for Estonian firms.

Firms in Estonia are typically private SMEs. Based on the official statistics there were 88 186 firms in Estonia as at the end of 2017, out of which 80 739 firms, i.e. 91,6%, had less than 10 employees and only 175 firms, i.e. practically 0%, had more than 250 employees (Statistics Estonia, 2020). There are only 16 firms listed on Tallinn stock exchange main list and 2 firms in secondary list as at October 2020. The corporate governance research tends to discuss mostly large public firms in large markets, but their situation is not comparable to Estonian firms. For example, small firms have substantially less information asymmetry and potential agency issues, especially as there tends to be significant overlap in ownership and management. This means that corporate governance focus needs not to be on that aspect, while in case of large public firms the managerial opportunism and other agency issues are very relevant. At the same time, small firms are characterized by lower resource base. Their human and social capital is much more limited compared to large firms, which means corporate governance should consider these aspects. Also, lower financial power sets limitations in the corporate governance design, which is another aspect that needs to be considered.

The thesis enriches existing academic literature with several novel aspects. Some novelties are related to the thesis in its entirety while some are related to specific Studies.

General novelties related to the thesis as a whole

The thesis takes a holistic and balanced focus on corporate governance. This is done by discussing the phenomenon from different viewpoints and applying several research methods. First, the thesis discusses the design of corporate governance bundle (Study 1) and how the governance bundle is associated with performance in both static (Study 2) and dynamic (Study 3) perspective. Second, the thesis looks at the firm performance from various perspectives: financial performance (Study 1 and 2), strategic performance (Study 3) and organizational effectiveness (Study 1). Third, the thesis applies different research methods to shed light on more nuances. The case study and qualitative analysis approach (Study 1) offers deeper sense-making of the phenomenon, i.e. how and why certain governance mechanisms are bundled together. The quantitative analyses (Studies 2 and 3) present associations between governance bundles (or changes in them) and firm performance. Fourth, the thesis is not limited to application of one particular theory. Instead, it builds upon several influential theories used in corporate governance research. This enables to reveal more nuances and avoids over-simplification. The above aspects support each other in expanding our understanding of the corporate governance in its wider complexities.

The thesis focuses specifically on private SMEs, which is an underexplored area within corporate governance domain. Previous corporate governance literature is dominated by research on large public firms while the private firm context is relatively less covered (Uhlaner et al., 2007, Li et al., 2020). This gap is unfortunate given that majority of firms globally are private (La Porta et al., 1999; Aminadav & Papaioannou, 2020). There are significant distinctions between the two groups, which means that issues to be dealt with corporate
governance are not the same, and studies performed in the large public firm context might not be fully relevant for smaller private firms.

The thesis focuses on governing firms in under-explored Estonian institutional setting. There is abundant literature on corporate governance in large markets (e.g. Anglo-American context) while other institutional settings are less focused on. However, the external context has impact on various governance practices (Aguilera & Jackson, 2010; Schiehll et al., 2014; Aminadav & Papaioannou, 2020) and therefore studies in different settings are called for.

Novelties related specifically to Study 1

First, Study 1 adds to the academic discussion on the interface between corporate governance and corporate social responsibility. The domain is relatively fragmented (Jain & Jamali, 2016) and some contexts, such as private SMEs are rather underexplored (Etapé-Dubreuil et al., 2016; López-Pérez et al., 2018). The study fills that gap.

Second, the Study presents and discusses a specific corporate governance bundle designed by professional private firm owners (private equity fund BaltCap) that enhances both financial as well as CSR performance of its investee firms: private SMEs. Focusing on how to govern small private firms is a crucial addition to the academic literature (Li et al., 2020).

Third, majority of studies on corporate governance and corporate social responsibility interface focus typically on large developed countries while smaller emerging markets, such as Estonia, have remained understudied (Jamali et al., 2017; Amos, 2018). The study fills that gap.

Novelties related specifically to Study 2

First, Study 2 is one of the few studies about association between corporate governance variables and failure risk within the private SME space. Although associations between corporate governance data and failure risk have been used in the large public firm setting, private SME context has been silent about it, with the exception of research by Ciampi (2015; 2017). The gap in literature is important as majority of firms globally are private SMEs and it has been shown that models developed for large public firms are not appropriate for private SME context (e.g. Altman & Sabato, 2007; Elshahat et al., 2015). Study 2 helps to fill that gap.

Second, Study 2 is based on the population of all SMEs in Estonia using data from official business register, which means that the study is free from any sampling bias or self-reporting bias: typical limitations in similar research.

Third, association between corporate governance and failure has typically been studied based on a narrow subset of failure, i.e. bankruptcy or permanent insolvency, the Study 2 uses failure risk as dependent variable. Such broader indicator includes all important financial domains like liquidity, profitability and leverage, and enables to provide analysis in much wider scope. Furthermore, such broader indicator enables to connect the analysis into financial performance domain.

Novelties related specifically to Study 3

First, Study 3 focuses on the underexplored dynamic perspective (Boeker, 1997; Elsøge et al., 2018) on associations between change in corporate governance bundle, namely nomination of a new management board member, and strategic performance, represented as internationalization and diversification outcomes of private SMEs. Other studies in the field typically take a static view focusing on specific corporate governance characteristics, e.g. board size, heterogeneity and other typical board characteristics.

Second novelty factor of the paper is that it takes a more holistic approach compared to previous research by applying the same dataset for exploring strategic change in both
internationalization as well as industry diversification dimensions. Such approach allows making comparisons on the strengths of associations between nomination of new management board member and subsequent strategic changes in these separate growth dimensions. Previous studies typically have focused on either one dimension only.

Third, the Study explicitly analyses the scale and stability of these strategic changes, aspects that are typically overlooked in other studies.

Fourth, previous studies on executive succession and strategic change have been largely limited to large public firms in the US while other contexts have remained underexplored (Nakauchi & Wieserma, 2015). Study 3 fills that gap by analysing the whole population of private SMEs in Estonia.

**Research objectives and tasks**

The objective of the thesis is to extend our understanding on how corporate governance of private SMEs is associated with performance.

The following research tasks have been set for the thesis:

1. Build conceptual framework for studying corporate governance and its relation to firm performance on a general level (Section 1.1).
2. Present an overview of major theories of corporate governance (Section 1.2).
3. Discuss the specific aspects of governance in the contexts of firms being private, SMEs and domiciled in Estonia (Section 1.3).
4. Discuss various domains of firm performance (Section 1.4)
5. Identify and discuss gaps in the academic literature regarding links between private SME governance and performance (Section 1.5, empirical studies).
6. Outline research questions to be answered in the thesis based on literature review and research gaps (Section 1.5).
7. Perform and present empirical studies to answer the research questions (Studies 1-3).
8. Discuss and summarize the answers to research questions together with their contribution to literature and practice, limitations and future research directions (Section 3).

**Research design and summary of Studies**

The thesis consists of three empirical studies (Studies 1-3). The following paragraphs and Table 1 briefly summarise the Studies.

**Study 1** of the thesis has two main aims. First, it discusses connections between a firm’s broader and narrower performance, i.e. how the stakeholder perspective (represented as CSR performance) is important also for the financial performance of the firm. Secondly, it analyses how the top decision makers of the firm achieve the goals of shareholders as well as other stakeholders via developing appropriate corporate governance bundles. Using the case study approach, the paper focuses on a leading private equity firm (BaltCap) active in Estonia. Private equity funds are professional investors, whose business model includes investing into firms, developing them and increasing their value by (among other aspects) improvements in their corporate governance practices, and exiting the firms after some years (hopefully) at a significantly higher value. Their experience is deemed invaluable in understanding how to design appropriate corporate governance bundles that support both financial and CSR performance of private firms.

The case study method is useful for deeper sense-making and for how and why type of research questions and enables to get deeper insights on the why and how questions on the
interconnections of CSR, long-term financial performance and corporate governance. The paper applies the critical case approach, which enables to generalize that the corporate governance bundle created by professional private SME owners (private equity fund BaltCap) with the purpose of achieving both CSR and financial performance, is applicable also for other private SME owners with similar aims (Flyvbjerg, 2006). In order to establish theoretical generalizability we applied the following methodological principles (Andrade, 2009): decided on our unit of analysis (portfolio company), conducted theoretical sampling (the informant having enough knowledge and experience), established chain of evidence (both between primary and secondary sources as well as between interviews), conducted thematic text analysis and categorization until reaching theoretical sufficiency. Study 1 is based on various primary and secondary data. Secondary data included BaltCap’s annual reports, CSR code, Environmental, Social and Governance (ESG) reports for years 2011-2018 and overview of its investee companies. Primary data was collected through five semi-structured in-depth interviews plus a follow-up interview to get more details on any outstanding issues. First three interviews were with BaltCap’s representatives. After the first interview the questionnaire was slightly modified to cover new emerging themes. The interviews were transcribed and thematically analysed. The information received from these interviews was validated by two interviews with their portfolio companies.

In the context of the wider thesis the Study lays the foundation for discussing corporate governance bundles and how these are used for directing and controlling private SMEs.

Study 2 focuses on interconnection between corporate governance and financial performance of private SMEs. The paper specifically analyses how characteristics of key governance mechanisms, namely management board and owners, are associated with firm’s failure risk as specified by Altman et al. (2017). The failure risk measured as the Altman’s Score (failure prediction model number 2 in Altman et al. (2017), page 154) is an aggregate measure consisting of firm’s liquidity, profitability and leverage data, and as such gives a multidimensional view on firm’s financial performance.

The Study applies logistic regression method and is based on 67,058 Estonian SMEs, which is the full population of SMEs in Estonia in the year 2015. The study applies logistic regression with failure risk being a binary dependent variable and seven corporate governance characteristics (board size; board gender heterogeneity; board tenure; age of top managers; multiple directorships; ownership concentration and managerial ownership) being independent variables. The dependent variable – failure risk – was calculated based on the most universally applicable failure prediction study by Altman et al. (2017). This study covered millions of European firms, including firms from Estonia, and has high classification accuracy in Estonia. For each firm in the dataset the Altman’s Score was calculated and firms with Altman’s Score >0.5 were coded 1, and in the opposite case 0. The data both for dependent as well as independent variables were procured from the Estonian Business Register, which contains firms’ annual reports and up to date data regarding firms’ owners and boards. Thus, the data used in the study are factual.

The Study shows that, indeed, there is statistically significant relationship between four (out of seven) of the analysed corporate governance characteristics and firm’s failure risk. In the context of the overall thesis these findings support the notion that characteristics of corporate governance bundle is important for financial performance of a private SME.

While Study 2 takes a static look on relationship between corporate governance and firm performance, Study 3 takes a dynamic view. Specifically, the Study analyses association between linkages between appointment of a new management board member (arguably one of the most important corporate governance mechanisms) and subsequent various types of
strategic changes in the firm’s product-market scope. In essence, the Study explores linkages between the change in the governance bundle and change in subsequent strategic performance.

The study applies logistic regression analysis to find associations between the appointment of a new management board member (independent variable), which is one of the most critical governance bundle mechanisms, and different types of subsequent strategic changes (dependent variables): a firm starting to export, already exporting firm expanding to new export markets and a firm diversifying into new industries. Furthermore, for each of the strategic change types additionally scale and stability dimensions were analysed, so in total 3 models for each type (general, with scale criterion and with stability criterion). Consequently 9 binary logistic regression models were built (3 strategic change types times 3 models for each). Additionally, 3 ordered logistic models were built with the same independent variable and general strategic change (i.e. any of the strategic change types) as dependent variable. Applying scale and stability factors resulted in additional 3 ordered logistic regression models. The study is based on the population of Estonian firms that met certain criteria. The total dataset consisted of 16,941 SMEs. Data for the models was retrieved from Estonian Business Register and are, thus, factual. The analysis accounts for all episodes of a new board member being nominated in year 2013 and follows whether or not any of the strategic change types occurred in years 2014-2016.

The Study concludes that there is significant association between the appointment of a new management board member and subsequent strategic change in at least some areas of the product-market scope of the firm. The findings of the paper indicate that altering corporate governance bundle of the firm might be a promising tool for supporting desired strategic changes for the firm, and thus drive strategic performance.
### Table 1. Summary of individual studies.

<table>
<thead>
<tr>
<th>Study</th>
<th>Method</th>
<th>Data</th>
<th>Importance for the full thesis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Study 1</td>
<td>Case study</td>
<td><strong>Secondary data:</strong> BaltCap’s annual reports, CSR code, Environmental, Social and Governance (ESG) reports for years 2011-2018 and overview of its investee companies.&lt;br&gt;<strong>Primary data:</strong> 5 semi-structured in-depth interviews plus a follow-up interview.</td>
<td>Discusses how broader understanding of performance and considering various stakeholders is important and beneficial also for narrower financial performance of a firm.&lt;br&gt;Presents actual corporate governance bundle professional private firm owners (a private equity fund) use in governing their investee firms with the aim of achieving both narrow financial and broader CSR goals.</td>
</tr>
<tr>
<td>Study 2</td>
<td>Logistic regression</td>
<td>67,058 Estonian SMEs. Data from Estonian Business Register. <strong>Dependent variable:</strong> failure risk. <strong>Independent variables:</strong> board size; board gender heterogeneity; board tenure; age of top managers; multiple directorships; ownership concentration and managerial ownership.</td>
<td>Discusses association between various corporate governance mechanisms and financial performance (represented as failure risk) of SMEs.&lt;br&gt;Concludes that there is association between some of the governance mechanisms and financial performance of SMEs.</td>
</tr>
<tr>
<td>Study 3</td>
<td>Logistic regression</td>
<td>16,941 Estonian SMEs. Data from Estonian Business Register. <strong>Dependent variables:</strong> start of exports; expansion into additional geographic markets for already exporting firms; diversification into new industries, strategic change in general. For each of the dependent variables 3 separate models were calculated, 1) the variable in general, 2) requiring stability of the variable, 3) requiring the scale of the variable.&lt;br&gt;<strong>Independent variable:</strong> appointment of new management board member.</td>
<td>Discusses association between a change in a corporate governance bundle (in the form of nomination of a new management board member) and strategic performance of SMEs (represented as subsequent strategic change in the product-market scope of SMEs).&lt;br&gt;Concludes that there is association between the nomination of a new management board member and subsequent strategic change, albeit the strength of the association varies depending on the actual content of the change.</td>
</tr>
</tbody>
</table>

Source: Created by author.
Contribution of individual authors

All Studies included in the thesis are co-authored, the author of the thesis being the first author of all Studies. Study 1 is written jointly with Krista Jaakson, PhD, from Tartu University while Studies 2 and 3 with Oliver Lukason, Phd, from Tartu University. The contribution of individual authors was as follows.

**Study 1**

The research objective, research questions as well as research design were discussed and agreed upon together by both authors. Author of the thesis put together the draft of interview questions, co-author suggested additions and improvements in the questionnaires. Both authors performed secondary data analysis independently and findings were discussed jointly. Both authors participated in the interviews. All findings were discussed jointly and both authors contributed to the writing of the manuscript.

**Study 2 and Study 3**

The co-operation style and role divisions were similar in case of Studies 2 and 3. Both authors contributed equally in the development of research objective and research questions. Author of the thesis performed the literature review while the co-author was responsible for empirical data collection. Both authors were involved in regression modelling, presenting and interpreting the empirical results. Author of the thesis was responsible for the discussion of the results in the light of previous literature.

Acknowledgements
1. LITERATURE REVIEW AND RESEARCH QUESTIONS

The literature review is structured as follows (see Figure 1). The section 1.1. gives a conceptual overview of corporate governance. It discusses the key elements of corporate governance as well as shows how these elements are interconnected with each other. This is done in order to provide a general understanding of the field. The section 1.2. maps the main theories used in analysing corporate governance. This step is crucial for understanding the complexities and nuances of the domain. The section 1.3. builds on the previous two sections and focuses specifically on corporate governance of private SMEs in Estonian context. Section 1.4. presents the multifaceted field of firm performance. Literature review ends with specification of research questions for the thesis.

**Figure 1.** Structure of literature review.

1.1. Conceptual framework of corporate governance: key definitions and linkages

**Corporate governance** is defined as “a system by which companies are directed and controlled” (Cadbury, 1992). The functional parts that perform the direction and controlling tasks within that system are called **governance mechanisms** (Ward et al., 2009) that allocate authority, roles and responsibilities among owners, supervisory board and top management, i.e. the key decision makers of the firm (Roe, 2004). As the result, corporate governance affects strategic choices of the firm and thereby value protection, creation and distribution decisions within a firm (Aguilera et al., 2016). In other words, it is a vehicle for driving firm performance.

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1 As the thesis discusses specifically Estonian context, it is important to note that Estonia uses two-tier board system where supervisory and management boards are strictly separated. However, most firms in Estonia use the simplified structure without supervisory board and where management reports directly to owners (see section 1.3. for more details).
Governance mechanisms are further divided into **external** and **internal governance mechanisms** (Walsh & Seward, 1990). External, or market-based mechanisms are mechanisms that impact the firms from outside and thus are not under the firms’ control (see Table 2 for examples of external mechanisms). Yet, these mechanisms impact directly the governance choices of a firm and are there to help ensure managers respect the rights and interests of firm stakeholders, engage stakeholders with the firm, provide financial transparency and offer strategic guidance (Aguilera et al., 2015). External mechanisms are location-specific, they are influenced by factors such as local culture, commonly agreed principles of doing business etc. Therefore, external mechanisms are globally varied and are typically researched on national basis (e.g. Aslan & Kumar, 2014; Millar, 2014; Schiell et al., 2014; Yoshikawa et al., 2014; Hooghiemstra et al., 2015). Since external governance mechanisms are varied across the world, and they impact the firm actions as well as potential choice of internal governance mechanisms, they are also regarded as contingency factors in corporate governance research.

**Table 2. Examples of external governance mechanisms.**

<table>
<thead>
<tr>
<th><strong>External mechanism</strong></th>
<th><strong>Impact on firm governance</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal system</td>
<td>Laws and regulations set the “rules of the game” for firms in its jurisdiction: what is and what is not allowed. Law enforcement institutions (e.g. courts) look after following the rules. Limits managerial opportunism; reduces environmental uncertainty; creates capacity to obtain resources, etc.</td>
</tr>
<tr>
<td>External auditing</td>
<td>Reduces information asymmetry by providing assurance on the quality of financial statements; limits managerial opportunism; signals legitimacy etc.</td>
</tr>
<tr>
<td>Media</td>
<td>Potential reputation loss keeps managers in line; social control; reduces information asymmetry etc.</td>
</tr>
</tbody>
</table>


Internal, or organizationally based mechanisms are mechanisms that organizations can impose on themselves and through that impact their activities and performance. Internal mechanisms are not given from any outside constituency or institution, but organizations can choose and design their own mechanisms. Some examples of internal mechanisms are presented in Table 3.

**Table 3. Examples of internal governance mechanisms.**

<table>
<thead>
<tr>
<th><strong>Internal mechanism</strong></th>
<th><strong>Impact on firm governance</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Managerial incentive system</td>
<td>Alignment of interests of owners and managers and thereby reduction in agency conflict.</td>
</tr>
<tr>
<td>Management turnover</td>
<td>Threat of management turnover could serve as a control mechanism for managerial opportunism; actual management turnover could acquire necessary human or social capital for the firm.</td>
</tr>
<tr>
<td>Supervisory board control function</td>
<td>Limits managerial opportunism.</td>
</tr>
<tr>
<td>Supervisory board advisory function</td>
<td>Resource provision, e.g. knowledge, external connections, access to resources.</td>
</tr>
</tbody>
</table>
Management and supervisory board characteristics (e.g. age, experience, board size, gender heterogeneity)

The characteristics of individual supervisory or management board member, as well as collective characteristics of respective boards illustrate for example human and social capital available at the top of the firm, which either limits or enables certain activities and performance outcomes.

Source: Created by author.

There is no comprehensive list of possible governance mechanisms as it is possible to define the boundaries of various mechanisms differently. For example, the supervisory board could be called a governance mechanism (see e.g. Roe, 2004). But the mechanism could also be viewed in more granularity, such as separating supervisory board’s control and advisory functions (see e.g. Uhlaner et al., 2007), or by looking at the composition of supervisory board by a variety of characteristics, e.g. size, heterogeneity, experience etc. (e.g. Chaganti et al., 1985; Dowell et al., 2011). There is certain flexibility in the usage of terminology of corporate governance literature as it has evolved over time and across disciplines (Ocasio & Joseph, 2005), which a reader of the literature needs to account for.

Each firm, thus, is governed by a certain number of external and internal governance mechanisms, which together are called corporate governance bundle (Aguilera et al., 2008). The bundle may be disaggregated into external, or national governance bundle, which is location-specific, and given to the firm operating in that location, and internal governance bundle, which is firm specific. It is widely accepted that firm performance depends on the combined effect of all mechanisms applied, rather than any single mechanism. Therefore, governance mechanisms should not be viewed separately but in combination with each other, i.e. in bundles (Rediker & Seth, 1995; Aguilera et al., 2008; Ward et al., 2009; Misangyi & Acharya, 2014; Filatotchev & Wright, 2017). The reason for such bundling approach is that all mechanisms are linked together by complementarity and substitutability relationships. Complementarity means that addition of a mechanism to existing bundle interacts with the effect of other mechanisms in the bundle, and thus the overall effectiveness of the bundle changes. For example, in some contexts supervisory board’s monitoring role might not be sufficient in curbing managerial opportunism, but it could be complemented with pay system that aligns CEO’s and shareholders’ interests (Ward, 2009). Substitutability means that some governance mechanisms perform essentially the same function, and therefore could be substituted for each other without significantly affecting the overall functionality of the bundle. For example, monitoring by supervisory board could be substituted with monitoring by large shareholder (Rediker & Seth, 1995). Given these complementarity and substitutability effects, it is possible to design very different governance bundles by including or excluding certain internal governance mechanisms.

There are a few factors potentially impacting the choice of internal mechanisms. First, external and internal contingencies, or the context in which the focal organization operates, have a role in designing internal governance bundles. External contingencies are external governance mechanisms discussed earlier, i.e. factors such as legislation, culture and norms, that form the environment in which the firm operates. Internal contingencies are firm-specific factors such as firm size, its resources and capabilities and life cycle phase (Huse, 2005; Aguilera et al., 2008; Filatotchev and Allcock, 2010). Thus, contingencies imply that corporate governance mechanisms to be chosen into a firm’s governance bundle are influenced by these factors. Different types of organizations require different corporate governance mechanisms: there is no “best practice” that would fit everybody (Heracleous, 2001; Huse, 2005; García-Castro et al., 2013).
Secondly, each mechanism comes with the cost. Some costs are direct such as remuneration of supervisory and management board members, costs of risk management systems and auditor fees while some are indirect, or opportunity costs, such as managerial time spent on investor relations instead of strategic or operating activities (Aguilera et al., 2008). Thus, while in principle, a firm could add many governance mechanisms into the bundle to maximize complementarity effect, the cost of having all of these could outweigh the benefits and the impact on firm performance could be negative (García-Castro et al., 2013). The application of each mechanism should therefore be subject to a cost-benefit analysis.

1.2. Theories of corporate governance

The need for corporate governance practice and academic research grew out of the separation of management and ownership (Berle & Means, 1932). The main problem corporate governance research initially dealt with, was how to handle the agency conflict (Jensen & Meckling, 1976) between managers and widely dispersed shareholders of public firms. The agency theory states that the conflict potentially arises when shareholders (principals) delegate the operation of the firm to managers (agents) and the interests of the two parties are not aligned. The performance of the firm (and therefore return on investment for shareholders) depends on the decisions and efforts taken by the managers, but these are not fully observable for shareholders. Shareholders only see the outcome of managerial actions, but not the effort taken. Such information asymmetry creates possibilities for opportunistic behaviour for managers such as shirking (moral hazard), indulging in excessive perquisites and misrepresenting skills and abilities (adverse selection) in hiring process (Ward, 2009). In order to remedy such situation shareholders might try to align the interests of managers to the ones of shareholders via certain governance mechanisms, for example appropriate compensation or make inappropriate behaviour more difficult via effective control systems or monitoring function of the supervisory board.

From that initial and to date still the most dominant agency theoretical view (Aguilera et al., 2016) corporate governance research has expanded to cover much wider array of governance problems with respective remedial mechanisms and applying various alternative theoretical frameworks in diverse contextual settings with the aim of uncovering more complexities and nuances of corporate governance. One of the key reasons for the search for alternative explanatory theories was critique from various authors (e.g. Roberts et al., 2005; Kumar & Zattoni, 2019) of agency theory being too narrow or simplistic in its assumptions regarding human nature. Agency theory has its foundation in economics and finance domain, which could explain its limits in reducing the nature of a man to rational actor.

For example, stewardship theory, which has its roots in sociology and psychology, argues that managers are not necessarily opportunistic and self-serving but instead collectivistic, pro-organizational and trustworthy stewards (Davis et al., 1997). The stewardship theory proposes a range of non-financial motives for managerial behaviour, such as need for achievement and recognition, intrinsic satisfaction of successful performance, respect for authority and the work ethic (Muth & Donaldson, 1998). Consequently, the theory states that managers are interested in achieving high performance and acting in the interests of shareholders (Donaldson & Davis, 1991). These, different kind of assumptions regarding managerial motives call for different kind of governance mechanisms such as managerial empowerment through trust, collaboration, service and positive reinforcement (Gabrielsson, 2007; Knapp et al., 2011; Hernandez, 2012). However, similarly to agency perspective, also stewardship theory may be criticized as being overly naïve. As evidenced by various corporate scandals (e.g. Enron, Wirecard etc.), managers do not always act altruistically and in the best interests of the firm or its owners. Therefore,
both agency and stewardship theories offer valuable insights into the governance puzzle and should be viewed in the context of the focal firm (Knapp et al., 2011).

Corporate governance research based on solely agency theory has also been criticized for being concerned mostly about value protection and largely ignoring value creation side of organizations (e.g. Uhlman et al., 2007; Huse et al., 2011; Aguilera et al., 2016). Alternative theories have been applied to respond to that shortcoming. Resource dependence theory (Pfeffer & Salancik, 1978) has been used to emphasize that firms’ supervisory boards, an important mechanism within corporate governance bundle, have not only monitoring function, but they are also there to support management in their service and strategy roles (Zahra & Pearce, 1989). For example, supervisory boards could be a mechanism to form stronger links to firm’s environment and acquire essential resources required for sustainable competitive advantage (Barney, 1991). These resources could be for example specific industry or functional knowledge (e.g. Levinthal & March, 1993; Levitt & March, 1988), connections to important stakeholders (e.g. Haynes & Hillman, 2010; Hillman & Dalziel, 2003), etc. In this role the supervisory board reduces external uncertainty and reduces transaction costs related to environmental interdependencies (Williamson, 1981). In general, supervisory boards would be a source for strengthening the firm’s human and social capital base (Haynes & Hillman, 2010; Hillman & Dalziel, 2003).

Stakeholder theory (Freeman, 1984) takes the discussion on the purpose of the firm, and thus that of corporate governance. The theory notes that corporate governance discussions should not be limited to the dichotomy of owners and managers and how managers should be focusing on assuring shareholders a return on their investment, as typically suggested by economics and finance domains (e.g. Shleifer & Vishny, 1997). Instead, the theory notes, there are various other parties, or stakeholders, that provide firm-specific contributions and thus participate in firm’s value creation, and therefore should be taken into governance equation and participate also in the value distribution (Garcia-Castro & Aguilera, 2015; Aguilera et al., 2016). There is no finite and comprehensive list of stakeholder groups, but they typically include owners (or investors), employees, suppliers, customers, communities, governments, social and environmental activists, etc (Donaldson & Preston, 1995; Mason & Simmons, 2014). The relevance of each stakeholder group to each particular firm depends on the context. Certain stakeholder groups might be relevant for some firms and not for others, also the relevance of stakeholder groups to a particular firm may change over time. For example, Mitchell et al. (1997) put forward a framework that help the management in identifying important stakeholders based on three factors: 1) whether they have some sort of power over the focal firm (i.e. they can influence the firm), 2) whether their claims to the focal firm have legitimacy (e.g. based on contracts or on moral grounds), and 3) the level of urgency of stakeholders’ claim (i.e. criticality and time-sensitivity of the claim). Relevant stakeholder groups depend on each other in value creation of the firm but have different and potentially conflicting goals. So, when accepting that the purpose of the firm is to serve all these relevant stakeholder groups, the question for corporate governance transforms from solely assuring the financial return for owners, a narrow definition of performance, into finding a balance in satisfying the needs of all relevant stakeholders, a broader definition of performance (Aguilera et al., 2008; Harrison et al., 2020).

While the previously discussed theories focus on organizational level, institutional theory (North, 1990), on the other hand deals with factors, or institutions, outside organizations that impact organizations. Institutions are socially constructed assumptions, values, beliefs, as well as formal and informal rules (Aguilera et al., 2018), that set the legitimate “rules of the game” (Aguilera et al., 2015) and therefore provide stability and meaning (Judge et al., 2008). Doidge et al. (2007) have found that country-level corporate governance institutions significantly
impact the governance of firms, for example, by making some potential internal governance mechanisms unavailable or unreasonably expensive. Therefore, it is essential to study corporate governance of a firm keeping in mind the institutional context in which it operates (Judge et al., 2008).

1.3. Private SME governance in Estonian institutional environment

Research on private SME governance in Estonia involves three types of contingency factors, which all impact corporate governance bundles. First, the focal firms are private, i.e. they are not publicly listed on any stock exchange. Second, the firms are small or medium-sized\(^2\), i.e. large firms are excluded from this group. Third, the firms operate in Estonian institutional environment. In the following paragraphs the thesis stipulates the main implications from each of the three contingencies.

Private versus public firms

While private firms as a group are quite heterogeneous, there are still several recurring specific characteristics that have implications on corporate governance.

The shares of private firms are not publicly traded, which means that the ownership structure as well as owners’ roles and expectations tend to be significantly different from publicly traded firms. Private firm owners are more connected to their firms. Their wealth is tied to the wellbeing of their firms (Ciampi, 2015), as opposed to public firms who typically have small shareholders with diversified portfolios. Public firm shareholders typically own very small fraction of the firm and thus have little or no incentives to monitor managers or seek to influence managerial decisions (Denis & McConnell, 2003). It is easier for them to sell their shares and invest somewhere else, when they are not happy with the actions taken or results achieved by the firm management (Connelly et al., 2010). For private firm owners the selling of their firms is much more difficult, which means they are more interested in the performance of the particular firm and the role of owners becomes more relevant in the corporate governance.

This is also stressed by the fact that private firms tend to have concentrated ownership (La Porta, 1999), which means the power relationship vis-à-vis the management is different. It is much easier for concentrated owners to make changes in the management compared to dispersed shareholders of public firms. So, instead of selling their firm, the owners might make changes in the management to put the firm back on their preferred track. Private firm owners, tend to have longer time perspective and broader success criteria than only financial results (Huse, 2005).

In addition, the separation of ownership and management is not that clear-cut for private firms, i.e. the ownership and management tend to overlap (Huse, 2005; Brunninge et al., 2007). This means there is less information asymmetry between managers and owners and therefore less opportunities for managerial opportunism. In other words, the agency problem as discussed in the agency theory is relatively less important compared to public firms (Uhlmaner et al., 2007; Machold et al., 2011). Instead of such agency issues between owners and managers, a potential conflict between controlling owner(s) and minority owner(s) becomes more relevant. Majority

\(^2\) The thesis applies European Commission’s definition for SMEs, i.e. a firm must meet two criteria to be considered an SME: 1) the headcount of a firm should be less than 250, and 2) either the turnover should not exceed EUR 50 million, or the total balance sheet should not exceed EUR 43 million (European Commission). It should also be noted that the SME definition used in this thesis also includes micro-firms.
owners might, for example, engage in value tunnelling at the expense of minority owners (Denis & McConnell, 2003; Roe, 2004), so corporate governance bundle should deal with that issue.

SMEs versus large firms

SMEs tend to have less resources than large firms, which means that they cannot afford large management boards. However, since the management is responsible for formulating and executing strategic decisions of the firm, it is critical that the small management board has the right qualifications that support fulfilling the goals of that particular firm (Cowling, 2003). This means for the owners and supervisory board of SMEs that selection, motivation and potentially replacement of the CEO and other management team members are the key governance mechanisms. Given that small firms tend to have concentrated ownerships, it is relatively easy (at least compared to large public firms) for the owners to make changes in the management board.

Another critical governance mechanism for SMEs is the supervisory board, especially in its resource provision role (Van den Heuvel et al., 2006; Machold et al., 2011). Supervisory board members could compensate for managerial deficiencies in SMEs by, for example, bringing specific knowledge and connections, advising in strategy making, representing firm interests in the community, etc. Given the low resource pool of SMEs, such resource provision role adds higher value for small firms compared to large ones (Huse, 2005). However, in reality SME supervisory boards tend to act only within the formal role given by the law (ibid.) and the potential upside value from supervisory boards remains untapped, especially in case of family firms (Brunninge & Nordqvist, 2004).

The low resource pool of SMEs also means that the cost aspect of choosing internal governance mechanisms is a limiting factor. For example, extensive control systems or hiring expensive consultants are typically unaffordable.

Estonian institutional context

Estonia is a member of European Union (since 2004) and euro-zone (since 2011). The formal institutions, such as legislation and judicial system are harmonized to general European frameworks.

Estonian Commercial Code (2020) permits several types of legal forms for firms. Two main ones are Private Limited Company (in Estonian “Osaühing”; later referred to as PrLC) and Public Limited Company (in Estonian “Aktsiaselts”; later referred to as PuLC). Other types are relatively rare in practice. In terms of corporate governance, PrLCs have a simple structure of one-tier board (the management board), which is subject to owners of the firm. It is possible also to set up the supervisory board for PrLCs, adopting the two-tier board system, but that is voluntary and rare. PuLCs have two-tier board with a clear separation of supervisory and management boards. The management board manages the firm and reports to the supervisory board and not directly to owners of the firm. The supervisory board plans the activities of the firm, organises the management of the firm and supervises the activities of the management board. Supervisory board is responsible for selecting and removing the management board members. The members of one of the boards may not be members of the other board, i.e. in Estonia there is no Chairman-CEO duality problematics, which is a typical debate question in Anglo-American system. Supervisory board members are elected and removed by the General

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3 The English translation of Aktsiaselts to Public Limited Company is somewhat unfortunate and could be slightly confusing as Aktsiaselts is not public in the sense of being traded on a stock exchange.
Meeting of shareholders, which is the highest managing body of a PuLC. In practice, most firms use the simplified PrLC structure.

Majority of firms in Estonia are private with only 16 firms listed on Tallinn Stock Exchange main list (as at October 2020). Majority of firms are also SMEs. According to Statistics Estonia (2020) there were 88 186 firms in Estonia in 2017. Out of these, 80 739 firms had less than 10 employees and only 175 firms had more than 250 employees. Estonian firm ownership landscape is characterized by family-ownership and also domestic as well as foreign outside owners. Thus, the ownership structure is different from Anglo-American, which is characterized by diffused ownership, but also from so-called German system, where the role of banks in corporate governance bundle is very high (Alas & Elenurm, 2014).

In terms of informal governance institutions such as business culture, norms and values Estonia could still be considered a transitory country (Vadi, 2018). Such aspects take significantly longer to transform and should be considered as an important context factor.

Estonia regained its independence from the Soviet Union in 1991 and early 1990s marked the period of privatization of firms. By 1995 the period of privatization was predominantly over and the initial legislative framework regarding corporate operations had started to develop. (Alas & Elenurm, 2014; Kooskora, 2015). The Estonian Commercial Code is largely based on the German version of Continental corporate governance model (Alas & Elenurm, 2014). During these early years of capitalism, the owners lacked corporate governance experience and long-term strategic vision (Alas & Elenurm, 2014). The main business purpose was fast profit and activities focused on short-term interests, no more than 1-3 years ahead. New millennium extended the attention to longer-term perspectives, from 5 to 10 years (Kooskora, 2008, 2015). The Soviet occupation had left significant traces in people’s morality and attitudes, so during the initial years of re-independence the business ethics and corporate social responsibility issues were new to firm owners and managers. These aspects were seen rather irrelevant as firms struggled to survive and focused on financial performance. During more recent years the attitudes have changed as more and more business leaders look at the performance more widely and consider also ethical, social and environmental aspects of business (Kooskora, 2015).

Thus, in general, the informal side of external governance institutions have been gone through rapid development during past 30 years. The development continues but the background from where the key actors of corporate governance (owners, supervisory and management board members) come from, should be considered when discussing corporate governance in Estonia.

1.4. Performance domains

Business performance is a complex and multidimensional phenomenon (Dess & Robinson, 1984; Rauch et al., 2009; Richard et al., 2009). Venkatraman & Ramanujam (1986) offer in their seminal paper a framework for discussing different levels of business performance (Figure 2). In their view, the narrowest conception of business performance focuses on financial indicators (such as sales growth and profitability) that are assumed to reflect the fulfilment of economic goals of the firm. The next level adds strategic measures (e.g. strategic changes such as new product introduction or geographic expansion) to the performance mix. These measures may also be viewed as leading indicators for financial performance. The third level takes into account the multiple and sometimes conflicting goals of various stakeholders of the firm and deals with the goal attainment of these stakeholders.
Furthermore, within each domain of performance, substantial multidimensionality remains with variety of potentially available measurement indicators. For example, Combs et al. (2005) analysed how organizational performance has been measured in Strategic Management Journal articles in period of 1980-2004 and identified 56 distinct measures that would fall into the two inner layers of the business performance framework on Figure 2. Majority (82%) were related to financial performance and accounting returns was the most common choice within the financial indicators group (52%). Related to specifically private firm performance measurement, Murphy et al. (1996) examined the empirical entrepreneurship literature for years 1987-1993 and observed 71 different measures for performance, predominantly focusing on financial, but partially also strategic domains of performance measurement. The multitude of potential measures illustrates the complexity of the firm performance assessment.

An important aspect regarding performance measurement is the objectivity-subjectivity scale and measurement level of difficulty of various indicators. Financial performance indicators are generally considered to be more objective and easier to measure than strategic indicators (Richard et al., 2009). Organizational effectiveness is considered to be most subjective and difficult to measure, even to the point that Venkatraman & Ramanujam (1986) considered it practically inapplicable and suggested to focus mainly on the two inner layers. Later research and debate on the topic still encourages to include also these more subjective measures of goal attainment of various stakeholders, or the organizational effectiveness layer in Figure 2, into the performance measurement mix (Harrison et al., 2020). Constructs such as Environmental, Social and Governance (ESG), Corporate Social Performance (CSP), Corporate Social Responsibility (CSR), triple bottom line, balanced scorecard etc. are embodiments of attempts to measure the more subjective goal attainment of wider range of stakeholders.

1.5. Summary of literature review, research gaps and research questions of the thesis

Corporate governance is a system by which firms are directed and controlled, and thus it is a vehicle for driving firm performance (see Figure 3). This is done by various governance mechanisms, some of which (external mechanisms) are given to a firm from external environment, and some (internal mechanisms) are discretionery. This thesis and its empirical studies focus specifically on internal mechanisms, as these are the ones the firm can choose and design for itself. External mechanisms are given for firms from outside and they are

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*The author has re-labeled the domains to match the terminology of this thesis.*
considered only as contextual factors. The key contextual factors for the thesis are the firms being private, SMEs and domiciled in Estonia. There are various theoretical paradigms used in explaining corporate governance and it has been found especially useful to apply several theories simultaneously in corporate governance research, given the complex nature of the phenomenon (Li et al., 2020). Therefore, the thesis and its Studies are not limited to any one theoretical paradigm but rather combines various theoretical viewpoints. Firm performance is a multi-dimensional construct involving financial, strategic and organizational effectiveness dimensions. The thesis explores the linkages of corporate governance to all of these domains, as called for by several authors (e.g. Venkatraman & Ramanujam, 1986; Murphy et al., 1996; Combs et al., 2005; Richard et al., 2009).

The thesis aims to extend our knowledge on the linkages between corporate governance and performance in the context of private SMEs in Estonia. In order to do that, three research questions have been set for the thesis, as specified and briefly justified in the following paragraphs (detailed discussion of research gaps is provided in empirical studies).

It is important to note that majority of previous academic literature focuses on large public firms in large countries (especially Anglo-American markets) while private SMEs and other institutional settings are less covered. Since it has been shown that these contextual factors have an important role in the design of corporate governance bundles and the links to performance, it is crucial to study specifically these under-explored settings. Therefore, the thesis and all of its empirical studies focus specifically on private SMEs in Estonian context.

As discussed earlier, viewing corporate governance mechanisms in bundles is considered the appropriate approach in analysing the linkages to firm performance. Therefore, it is imperative to first explore the potential design of effective governance bundles in the context of Estonian private SMEs. While there always will be differences in details of the corporate governance bundles across firms, it could be argued that the mentioned contextual factors limit the variability sufficiently to discuss the general bundle that could be used in driving firm performance both in narrow financial and broad organizational effectiveness dimensions. In order to discuss effective corporate governance bundles, which internal mechanisms to include in it, and why, it is useful to study professional private SME owners, such as private equity funds. The core competence of private equity funds is to increase value of private firms (in

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**Figure 3.** Framework for studying associations between corporate governance bundle and performance. Created by author.
Estonian case, typically SMEs) via improved corporate governance, i.e. their experience and knowledge is invaluable. Therefore, the first research question of the thesis is the following:

**RQ1. How to design a corporate governance bundle that support both financial performance and organizational effectiveness goals of private SMEs in Estonia?**

The next step after establishing the foundations of corporate governance bundle design, is to explore whether there are connections between key corporate governance variables, such as management board and owners, and firm performance. There is voluminous literature about links between corporate governance and financial performance, but there are several issues that still require scholarly attention. First, private SME context is relatively under-explored. Second, studies within the private firm context usually suffer from data availability issues leading to various biases such as self-reporting or sampling bias. In Estonian context the problem can be overcome as both corporate governance as well as financial data for all firms in Estonia are publicly available in the official database: Estonian Business Register. Thus, studying association between corporate governance and financial performance in Estonia allows to work with factual data across the population of firms. Therefore, the second research question is as follows.

**RQ2. Is there a linkage between characteristics of management board and financial performance of private SMEs in Estonian institutional environment?**

It could be argued that financial performance of a firm is a lagging indicator while strategic performance is a leading indicator. In other words, financial performance is driven by strategic performance. One of the key aspects of strategic performance is an ability of making strategic changes, which is arguably a difficult task due to factors such as organizational inertia. However, literature has shown that appropriate corporate governance bundle could help in carrying out strategic changes such as expansion in firm scope. The available literature, though, has various limitations that still leave gaps in our knowledge. For example, previous studies have mostly looked at links between corporate governance and strategic changes from a static perspective, i.e. independent variables in these models have tended to be typical corporate governance characteristics such as board size, heterogeneity and so on. There are only very few studies that take a dynamic perspective, i.e. look at how changes within corporate governance bundle are associated with subsequent strategic changes. Also, previous studies looking at links between corporate governance and strategic performance have mostly focused on large public firms while private SMEs have been relatively neglected, typically due to the same data availability issues discussed under RQ2, leaving an important gap to be filled. Therefore, the third research question of the thesis is as follows.

**RQ3. Is there a linkage between nomination of a new board member and subsequent strategic change in case of private SMEs in Estonian institutional environment?**
2. EMPIRICAL STUDIES
3. DISCUSSION OF RESULTS AND CONCLUSIONS

3.1. Discussion of research questions

This section discusses the findings from empirical studies in relation with the objective and research questions of the thesis. The discussion relates the results from separate studies with each other and gives meaning to these findings in relation with the objective of the full thesis.

RQ1. How to design a corporate governance bundle that support both financial performance and organizational effectiveness goals of private SMEs in Estonia?

Corporate governance could be viewed as a vehicle for driving firm performance. This, of course, means that in order to use corporate governance in such an instrumental way, there should be clarity in goals, what the governance bundle should strive to achieve. The literature contrasts shareholder and stakeholder views arguing whether the management should focus on maximizing shareholder value and ignoring other stakeholders, or should it try to balance the often-conflicting interests of all stakeholders (including shareholders). Study 1 provides some interesting insights regarding that dilemma. The case study firm – private equity fund BaltCap – holds a pro-stakeholder view as the basis of their corporate governance design, and as such is in line with proponents of applying stakeholder theory in the corporate governance domain (e.g. Freeman, 1984; Aguilera et al., 2008; García-Castro & Aguilera, 2015; Harrison et al., 2020). Interviews held as part of the Study 1 bring out several points that show how broader goal attainment of various stakeholders serves also the financial goals of owners.

First, a distinction should be made on the financial performance over short and long periods. In short time frame the management could maximise returns for owners at the expense of other stakeholders. But in the long run, that would be detrimental also for the owners. For example, lay-offs or paying minimum wages for employees might increase profits for the short time frame, but losing experienced employees limits firm growth opportunities, or even survival, in the longer run. Being negligent about environmental, social or local community issues might save expenses and increase profits in short run, but negative image and bad publicity (examples of external governance mechanisms) could create problems over longer periods as consumers might be put off by firm’s irresponsible actions. While managers in public firms are typically pressured for short term quarterly results by small, diversified and often non-committed shareholders, private firm owners cannot sell their shares that easily as their firms are illiquid assets, and thus are more stable in their ownership role and could afford a longer-term view on the firm actions. Such stable and concentrated ownership potentially relieves the short-term pressure on management and enables to take longer perspective on firm actions. Of course, it does not mean that this is always done.

Second, financial returns for owners are typically gauged in net profits or other similar profitability measures, but alternatively increase in intrinsic value of the firm could be prioritized, as was in the case of the private equity fund. While actual net profits are historical facts and thus backward-looking, intrinsic value (for example calculated based on discounted cash flow method) depends on future cash flows and riskiness thereof, and thus is forward-looking. Therefore, sacrificing short term profits for strengthening its resource base, including immaterial resources such as customer and supplier relations, employee engagement or reduced environmental impact might improve future cash flows and reduce riskiness thereof, which in turn increases the value of the firm. Focusing on historical financial results is clearly an easier task than considering the potential future outlook, which is quite a subjective estimate. However, the private equity sees clear value in focusing on future, even if it is not that
objectively measurable. Of course, this does not mean that current results would not matter at all. These objectivity-subjectivity and backward- or forward-looking performance measurement dilemmas add to related academic debates held by authors such as Venkatraman & Ramanujam, (1986), Richard et al., (2009) and Harrison et al., (2020).

Third, stakeholder goal attainment and owners’ financial returns could be viewed through the value creation and value protection prism. The more value a firm creates to all stakeholders, the more value there potentially is also to owners’ financial returns. So, the corporate governance bundle should not merely deal with protecting owners’ financial interests, but also emphasize the value creation of a firm, which is in line with arguments brought forward by authors such as Uhlaner et al., 2007, Huse et al., 2011 and Aguilera et al., 2016. Thus, based on findings of Study 1, it could be argued that in the long run organizational effectiveness dimension on performance, i.e. goal attainment of all stakeholders, is beneficial also for owners’ financial interests. Governance mechanisms in the bundle should support both of these goals.

Study 1 also provides a template on how to design a corporate governance bundle for private firms in Estonia that would help achieve both financial and organizational effectiveness goals. Figure 4 presents the private equity logic for building such governance bundle by showing schematically the key activities owners and supervisory board do and what are the related governance mechanisms resulting from these activities. Also, focus area addressed by respective mechanisms is identified by colour codes.

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**Figure 4.** Template for designing private SME corporate governance bundle in Estonia. Created by author
Before explaining the logic of Figure 4, a few comments need to be made. First, as discussed in section 1.3 Estonian laws allow for the firm not to create a supervisory board. For very small firms with very low resource base that option might be feasible as the costs of value adding supervisory board might outweigh the benefits. In that case the Figure 4 should be adjusted so that the supervisory board’s activities would be performed by owners themselves. Second, the model is a simplification of reality. In actual life there are more links between variables than just the relatively linear depiction of the main interactions, also additional activities or mechanisms might be relevant in certain contexts. Furthermore, governance mechanisms might have other or manifold addressable theoretical governance issues. The area depicted on figure is the typical logic used in the literature. For example, code of conduct or managerial key performance indicators are viewed as vehicle for capping managerial opportunism or inappropriate behaviour, i.e. the mechanism addresses vertical agency problem and, therefore, focuses on value protection. However, the same mechanisms might also be viewed as vehicles for empowering of or providing strategic counsel for the management, i.e. mechanisms for value creation.

The key principle within the framework for value creation as well as protection is active ownership. Active ownership starts from understanding and articulating the goals of the firm, i.e. what kind of performance is expected in all discussed domains, and what are the key principles based on which the performance is sought after. When there is more than one owner in the firm, then having an agreement regarding these goals and principles is advisable. For example, the shareholders’ agreement could be an appropriate governance mechanism for that. Based on the private equity experience in Study 1, discussing, negotiating and signing such a document is a great way in aligning the interests of all owners. Such document also serves as a governance mechanism for protecting the interests of minority owners and thus deals with horizontal agency issues (Roe, 2004). Such common goals and working principles from owners’ side makes it easier to communicate and align interests with the management team via, for example, related governance mechanisms such as managerial key performance indicators (including also wider performance indicators dealing with stakeholders in the organizational effectiveness domain, e.g. in the form Environmental, Social and Governance indicators used by BaltCap in Study 1), incentive systems and codes of conduct, that incentivize the management to work towards the goals within the limits of agreed-upon working principles. Such governance mechanisms alleviate vertical agency issues (Jensen & Meckling, 1976; Roe, 2004; Ward, 2009). These mechanisms complement each other (Rediker & Seth, 1995; Aguilera et al., 2008) and alleviate potential agency conflicts between owners and managers as well as between different owners.

Active ownership does not necessarily mean that owners should also manage the firm, although results of Study 2 indicate that when owners are in the management board, at least the financial performance tends to be better. Alternatively, owners could take an active stance also by staffing active and competent supervisory board as well as participating in the work of the supervisory board. The experience from private equity fund presented in Study 1 shows that the key governance mechanisms to be included in the bundle revolve around selecting and incentivising the management team, staffing a functional supervisory board and creating a good and supporting work atmosphere within each and between the two. Indeed, Study 1 interviewees emphasized that private equity largely “invests into management of the firm”, i.e. the qualities of the management team are a pre-requisite for superior performance of a firm. Importance of managerial characteristics is also evident from Studies 2 and 3. Results of Study 2 indicate that some individual and collective traits of management board, e.g. management board size and managerial age profile, are associated with financial performance (see also
discussion under RQ 2). Similarly, Study 3 shows that nominating new management board members, i.e. altering the human and social capital of the management board, is supportive of subsequent strategic changes of the firm, i.e. strategic performance of the firm is related to managerial characteristics (see also discussion under RQ 3).

Supervisory board as a governance mechanism has an important role within the private equity model. Staffing the board with experienced and motivated people is seen as a source for value creation. This is in line with academic arguments brought forward by authors such as Uhlman et al., 2007 and many others. Private equity in Study 1 prefers relatively small supervisory boards of five people. Nonetheless, as the boards are still bigger than the minimum required by Estonian law (three members), it indicates that private equity sees value in recruiting these people in the board. The supervisory board size reflects on one hand cost-consciousness (a relevant contingency factor for SMEs), but also more focused team-work within the supervisory board. Results of Study 2 show that in case of private SMEs smaller management team is associated with better financial performance. The finding may not be directly applicable also for supervisory boards, but some parallels may be drawn, subject to verification in future studies. The supervisory board has various roles in the private equity model as presented in Study 1. Their advisory and resource provision roles are governance mechanisms that have roots in resource dependence (Pfeffer & Salancik, 1978) and stewardship (Davis et al., 1997) theories and support the management in value creation. Their controlling role, on the other hand, is related to agency theory (Jensen & Meckling, 1976) and deals with value protection. Advisory, resource provision and controlling roles are acted on via regular and frequent contacts with the management team.

In summary, the corporate governance bundle template designed by private equity for its private SME investees includes several internal governance mechanisms as discussed above. The mechanisms work within the wider framework provided by external governance mechanisms applicable in Estonia, such as laws, regulations, professional and social norms, traditional and social media etc. Both internal as well as external governance mechanisms in the bundle collectively deal with value creation as well as stipulating principles for value division among stakeholders and value protection for shareholders. As such, the bundle could (and should) be viewed from several theoretical lenses – agency, stewardship, resource dependence, stakeholder and institutional – in order to grasp the complexity of corporate governance in a holistic manner.

RQ2. Is there a linkage between characteristics of management board and financial performance of private SMEs?

As discussed under RQ1, private equity fund considers the selection of appropriate management board as well as its relations with owners critical for the performance of private SMEs. Results of Study 2 provide some confirmatory evidence, that some characteristics of management board and ownership indeed have association with financial performance of private SMEs.

The Study 2 took a multidimensional view on financial performance. Namely, using the Altman’s Score (Altman et al., 2017), which is an aggregate measure consisting of indicators of liquidity, financial leverage and periodic as well as cumulative profitability. As the Altman Score was originally used for failure prediction, it could also be interpreted as a forward-looking performance measure. This links with the backward-looking accounting data versus forward-looking intrinsic value discussion under RQ1. It may be argued that by lowering the failure risk of a firm, the management increases the intrinsic value of the firm.
The findings from Study 2 indicate that smaller management boards, higher age of management team members, managerial ownership and being less engaged with multiple directorships were found to be associated with lower failure risk, or in other words, better financial performance. On the other hand, gender heterogeneity in the management board, tenure of the management board members and ownership concentration did not have any significant association with failure risk. A more detailed analysis by size and age groups gives a more mixed picture as presented on Table 4. The table summarizes whether a studied variable was found to be positive, negative or insignificant for financial performance. Note, that in Study 2 the dependent variable was failure risk, which is the inverse of financial performance (as defined in this thesis), i.e. the signs of variables compared to Study 2 are opposite. For example, while Study 2 presents that larger management boards have significant positive association with failure risk, Table 4 states that the association with firm financial performance is negative.

**Table 4. Summary of Study 2 results.**

<table>
<thead>
<tr>
<th>Variable</th>
<th>General result</th>
<th>Smaller firms</th>
<th>Larger firms&lt;sup&gt;5&lt;/sup&gt;</th>
<th>Younger firms</th>
<th>Older firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management board size</td>
<td>Negative</td>
<td>Negative</td>
<td>Negative</td>
<td>Negative</td>
<td></td>
</tr>
<tr>
<td>Gender heterogeneity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managers’ age</td>
<td>Positive</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multiple directorships</td>
<td>Negative</td>
<td>Negative</td>
<td>Negative</td>
<td>Negative</td>
<td></td>
</tr>
<tr>
<td>Tenure of managers</td>
<td>Positive</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ownership concentration</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managerial ownership</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
</tbody>
</table>

Source: Created by author. Note: For better visualization purposes the insignificant relationships were left empty.

A detailed interpretation of these results is presented in Study 2 and not repeated here. However, the broader themes emerging from these findings are the following. First, the findings illustrate the relevance of contingency factors and cost aspect of governance mechanisms in corporate governance research (Aguilera et al., 2008). For example, the analysis shows that larger management boards are negative for financial performance especially in case of smaller and younger firms. As firms get older and bigger, the relationship turns insignificant. Smaller and younger the firms are likely to be more resource-constrained, which means that the cost-benefit relationship of having larger management boards might be negative. While more management board members would increase firms’ human and social capital (Haynes & Hillman, 2010; Hillman & Dalziel, 2003) and might improve the quality of decisions (for example through adding perspectives and experiences), the cost of these additional management board members might outweigh the benefits from better decisions.

<sup>5</sup> The firms in the „larger“ group are still SMEs.
Second, it seems that the financial performance of small private firms is more linked to the speed of decision-making as opposed to more balanced but slower deliberation in the management board. This is indicated by the fact that variables related to potentially having multiple perspectives and experiences present in the management board (larger management board and gender heterogeneity) are either insignificant or negative for financial performance. Similarly, multiple directorships, a distracting factor, might slow decisions and is found to be negative in all cases, except older firms where processes might be more established and decisions delegated to lower levels. Also, overlap in ownership and management (variable managerial ownership), which removes the potential necessity of discussion between owners and managers, also speeds up decision-making and is positive for financial performance.

Third, managerial ownership alleviates the agency problem and is found to be positive for firm performance. This is an indication of importance of having right incentive system (another key governance mechanism) for the management, as also discussed under RQ1. The Study 2 did not analyse other potential managerial incentive systems (e.g. variable pay related to performance, option schemes etc.) and their relationship with financial performance of private SMEs, but that could be an interesting avenue for further research.

In general, it may be concluded from the findings that there is a linkage between characteristics of management board and firms’ financial performance. This is further supported by a finding from Study 3, which showed that there is a significant positive association between previous export experience of a new management board member and probability of the firm starting to export. The finding does not address directly financial performance of the firm but the intermediary step of strategic change. However, a firm starting to export is likely to have impact also on financial performance of the firm. Therefore, the composition and motivation of management board are indeed important governance mechanisms. Owners and supervisory board are advised to carefully select management board members with appropriate human and social capital that suit the context of the firm. Small firms might not afford several management board members (costs of several board members outweigh marginal benefits), so choosing the right person to lead the firm has paramount importance.

RQ3. Is there a linkage between nomination of a new board member and subsequent strategic change in case of private SMEs?

One of the conclusions from RQ1 and RQ2 was that composing the management team with members whose human and social capital are appropriate for the specific context of the firm is important for achieving superior performance. RQ3 takes the discussion one step further and adopts a dynamic view by analysing the association between change in the management board (i.e. change in corporate governance bundle), and strategic performance of private SMEs. Study 3 analysed strategic performance from the perspective of expansion of firm scope (Ansoff, 1957). Namely, whether after a nomination of a new management board member the firm expands into new industries or new geographic markets. In case of the latter the study analysed separately firms entering their first export market and already exporting firms expanding into additional geographic markets (this was done due to the difference in relative difficulties of these two expansion types). Expansion into new markets or industries requires firms to obtain new capabilities and make investments, and as such can be classified as strategic activities, and the outcome of these activities illustrates strategic performance of the firm. Although Study 3 did not specifically analyse it, such expansion in firm scope, if executed successfully, opens new growth areas and value creation opportunities for the firm, and as such also has the potential for improving financial performance of the firm.

The results of Study 3 found associations between change in the management board and different expansion types, although there were differences in the details. For example, it was
found that starting to export might benefit most from nomination of a new board member, especially if he or she has prior export experience. Diversification into new industries was also associated with prior nomination of a new management board member, although the significance level was lower (p<0.05 compared to p<0.01 in case of starting to export) while expanding into additional export markets for already exporting firms was not associated with prior change in the management board. There were also differences when analysing age and size control variables of firms. Detailed analysis and discussion of these findings is provided in Study 3 and not repeated here. Nonetheless, the wider conclusion related to the whole thesis coming out of these findings is that, indeed, managerial characteristics matter at least for some type of strategic performance. Bringing in new management board members might give firm a boost in making strategic changes and through that create additional value for the firm. This conclusion also illustrates the importance of resource-based theories (e.g. Barney, 1991; Pfeffer & Salancik, 1978) within the corporate governance domain. The explanation as to why new management board member(s) might bring about subsequent strategic changes might be related to new resources they bring with them. Resources such as specific knowledge, experience, connections in export markets or new industries, as well as personal traits such as ambition, energy level or leadership style all play a role in the value creation process of the firm and should be considered in the corporate governance bundle design.

In conclusion, selection of the management board members is a very important governance mechanism in the hands of the supervisory board and owners of the firm. This finding supports the conclusion from Study 2 that management board characteristics are linked with firm (financial) performance as well as in alignment with one of the key points from the Study 1 where private equity clearly stated that they invest largely in the management of the firm.

3.2. Practical implications

The thesis presents several practical implications for private SME owners who wish to improve the performance of their firms. Specific implications that have already been presented in each individual Study are not repeated here. Instead, the implications here are more related to the overall objective of the full thesis and as such combine the implications from individual studies to a more general level.

1. The thesis outlines different dimensions of firm performance ranging from narrower financial performance to broader strategic performance and organizational effectiveness. Awareness of these performance dimensions and how they are interlinked with each other as well as with corporate governance might be helpful for private SME owners in their performance targeting processes and corporate governance design endeavours. Better understanding in the importance of firm value creation in these dimensions, engaging relevant stakeholders into the value creation as well as distribution and focusing on the longevity of the business through adequate corporate governance design might be one of the keys to take private SMEs to the next level in their development.

2. The thesis, especially Study 1, discusses the importance of focusing on the long-term performance and how to do that. Previous studies have shown that Estonian owners and managers have been relatively short-term focused, although improvements in that area have been made. Hopefully this study pushes this progress further.

3. The thesis presents an actual corporate governance bundle used by professional private firm owners. This could serve as a template for other private SME owners for enhancing the performance of their firms. The details within the template might need to be adjusted for the context or goals of a particular firm, but the basic framework is still useful.
4. The thesis presents schematic guidelines for private SME owners and supervisory board members for designing and setting up a corporate governance bundle that supports both financial as well as organizational effectiveness performance dimensions.

5. The thesis shows the importance of active ownership. This does not necessarily mean that an owner should take managerial role in the firm. The activeness is related to being truly interested in the performance of the firm, supporting the management as much as possible by, for example, staffing the supervisory board with members that can provide necessary knowledge, connections or other resources and are able to hire, motivate and support the management board that is suitable for the context of the particular firm. The supervisory board seems to be an under-utilised resource in Estonia holding back the development of private SMEs.

6. The thesis highlights the importance of considering contingency factors when designing corporate governance bundles. For example, while composing a skilful supervisory board has value for a firm, it also incurs costs, which means firms with low resource base (e.g. micro-firms) might not be able to afford them – the cost-benefit analysis might yield negative result. Therefore, in this case the owner is probably advised to take the managerial role and carry the firm to the level where these additional mechanisms could be added to the governance bundle.

7. The thesis shows that by reconfiguring some key mechanisms within the corporate governance bundle, the owners might be able to change the course of the firm towards desired outcomes. Such corporate governance bundle alteration, in turn, would be an example of active ownership discussed under implication #4.

3.3. Limitations and avenues for further research

The separate Studies and the thesis as a whole are not without some limitations that provide avenues for further research. More detailed limitations and future research areas relevant for specific Studies are discussed in respective Studies. The following are more general limitations and future research opportunities in the context of the full thesis.

1. Detailed quantitative analyses (Studies 2 and 3) examined closely the characteristics of the management board and changes in the management board in relation with the financial and strategic performance of the firm. However, as presented in the Study 1, there are many other important governance mechanisms that were not covered in comparable depth and need to be studied further. For example, mechanisms like managerial incentive systems, designing and modifying performance measurement systems, nominating new or additional supervisory board members and altering the co-operation processes between supervisory and management boards might open new avenues for firm development. Studying these alternative governance mechanisms in relation with the firm performance would broaden our understanding in achieving superior private SME performance.

2. The previous research on corporate governance in SME context is fragmented and empirical analyses are lacking, which has led this thesis to adopt exploratory style using research questions in the attempts to discover connections between variables. Developing and testing hypotheses and possible causalities would be important areas for further research.

3. The thesis limited its analysis only on the internal corporate governance mechanisms. The external mechanisms stemming from the Estonian institutional context were taken as granted. As it is known that external mechanisms influence the internal mechanisms, it would be interesting to perform a similar study in slightly different institutional setting.
The findings and comparisons would be important for policy makers designing the external governance mechanisms (at least the formal ones).
REFERENCES


