

# Power Shifts and Board Roles in SMEs: A Multiple Case Study

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**Abstract:** The aim of this paper is to understand the functioning of boards and the roles they play in SME governance. Results from case studies of six small Tunisian firms revealed a range of board functions grouped according to four typical roles of control, strategy, service and mediation. The types of board involvement in firm decision making ranged among the case firms from a passive board classified as a “legal fiction” to a fully active “pilot” type of board depending on the relationship between the board and the CEO/founder and the firm's circumstances. SME governance under changing circumstances encompassed all four board roles but emphasis was placed on one or two key roles according to the strategic demands of the firm. In this context multiple board roles employed simultaneously are captured as a portfolio of roles and integrated within a contingency framework that aligns board competence with the firm's evolving strategic requirements.

**Keywords:** SMEs, board role portfolio, contingency, power dynamics

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## 1. Introduction

Changes in a board's role over time are relative to changing firm circumstances (Jonsson, 2005; Lynall et al., 2003) which are reflected in growing demands on boards (Huse, 2007) as well as being due to the increasingly complex nature of modern business. This paper examines the different roles that SME boards may play in different firm circumstances. The role of a board in an SME has been based primarily on the statutory requirements of boards in large, publicly accountable listed firms. This conceptualisation has been criticised in the literature on various grounds, not the least being that there is a great deal of heterogeneity among SMEs and a one-size approach to the role of a board in this context is inappropriate. An underlying assumption is that an unlisted SME would need or benefit from having a board of directors. However, acceptance of the idea of a board as necessary and/or desirable for a small firm often meets with strong resistance or outright rejection by a powerful owner/founder/CEO who may perceive a board and sharing of power and control as a direct threat. Nevertheless, a particular stage in a firm's growth may signal the requirement for establishing a formal board of directors and the resolution of issues of power at the governing apex of the firm.

The literature has paid some attention to the type of role an SME board can play to add value to the firm, based mainly on resource dependency theory. However, there is a lack of consensus beyond the recognition that whatever role is adopted by an SME's board, it will of necessity change as the firm's circumstances change. Roberts, McNulty and Stiles (2005) noted that existing theorisations based variously on agency theory, agency versus stewardship theory, control versus collaboration, or the control, service and resource functions of the board, portray inadequately the conduct and practices they observed in boardrooms. This highlights a need for a holistic, integrated consideration of board roles which is consistent with organisational objectives, and is more indicative of the reality within which boards operate, especially in SMEs.

## 2. Theoretical background

The literature on SME board roles has built upon many different theoretical perspectives. The wider corporate governance literature from which the SME governance literature derives identifies a variety of different roles that boards of directors may adopt in decision-making. The *control*, *service* and *strategy* roles have emerged in this literature as the principal board roles and these have been studied from a variety of theoretical perspectives (Zahra and Pearce, 1989; Gopinath, Siciliano and Murray, 1994; McNulty and Pettigrew, 1999; Hung, 1998; Maasen, 1999). Stakeholder theory and team production theory have indicated a fourth board role of *mediation* among multiple stakeholder coalitions with divergent and/or competing interests (Corbetta and Salvatto 2004; van Ees, Gabrielsson and Huse, 2009).

Table 1 summarizes the main theoretical perspectives derived from the literature, as well as the associated board characteristics and role focus.

**Table 1:** Main theoretical perspectives

| Theory  | Board characteristic  |                 | Board Roles  |
|---|---|-----------------|--|
| Agency theory                                 | Controlling body  |                 | Monitoring<br>Compliance, conformance and external accountability  |
| Stakeholder theory/<br>Team production theory | Integrating body  |                 | Arbitration, mediation and interface with stakeholders (alignment of interests)  |
| Strategic leadership theory                   | Directing body  |                 | Leading and guiding strategic direction<br>Establishing organisational culture (values, ethical conduct, ethos)<br>Advising and counselling management |
| Upper echelon theory                          |   |                 | Shaping major organizational outcomes<br>Influencing the process of strategic choices  |
| Stewardship theory                            |   | Supporting body | Legitimizing managers<br>Empowering managers<br>Providing key expertise  |
| Cognitive perspectives                        |   |                 | Providing key expertise (decision support)<br>Acting as decision making experts  |
| Managerial hegemony theory                    | Advising and counselling management<br>Providing key expertise (decision support) |                 |  |
| Resource dependence theory                    | Connecting body   |                 | Procuring external resources<br>Managing environmental uncertainty   |
| Social network theory                         |   |                 | Making connections through key relationships   |

Adapted from Karoui, 2009

By integrating within a portfolio conceptualisation the various roles presented in the table we argue that such theoretical pluralism provides a more adequate approach to understanding the board’s multiple obligations, especially in an SME context. In this conceptualisation the portfolio of board roles involves linking, supporting, integrating, monitoring and directing tasks where the board acts as a provider, monitor, controller and arbitrator of key resources. Rather than seeing the choice of role as a single function selected from the range of options as presented in Table 1, the portfolio concept promotes the idea that a board may select and play simultaneously a combination of control, service, strategy (Demb and Neubauer, 1992) and mediating (Blair and Stout, 2001) roles but emphasise a particular role that matches the strategic requirements of the firm’s circumstances (Hillman et al., 2000; Pfeffer, 1972; van Ees et al., 2009). The combination of roles employed by the board will determine the relative emphasis in balancing the two governance dimensions of regulatory conformance/compliance and organisational performance.

## 2.1 Control, service, strategy and mediating roles

The *control* role of the board is consistent with the conformance (or regulatory compliance) dimension of corporate governance (Charreaux, 2000). Derived from agency theory the board’s main role is organised around the generic concept of the monitoring function (Huse, 2007). This role emphasises financial control and monitors past performance through financial accounting methods. The board’s control activities also include monitoring firm strategies, appraising the CEO’s behaviour and the executive leadership team’s performance, defining the executive remuneration policy and assessing the nomination and/or dismissal of executives and/or directors (Matheson, 2004).

The board's *service* role draws primarily upon resource dependency theory. In this role the board makes three main contributions: (1) legitimisation (Huse and Zattoni, 2008), (2) external linkage (Hillman et al., 2000) and (3) information gathering, advice and counsel (Davis et al., 1997; Muth and Donaldson, 1998). The service role may contribute to improved decision quality and therefore affect positively long-term firm performance.

The board's *strategic role*, according to Zahra and Pearce (1989), includes encouraging discussion and debate, evaluation and, potentially, the initiation of strategic proposals. In this role, directors may make a strategic contribution to the firm from their professional expertise and experience, in the formulation and refinement of strategies. In addition to articulating the firm's mission and setting guidelines for implementation and control of strategy, boards acting in a strategic role may also make a major contribution at critical decision points, such as acquisitions, divestments or takeover bids (Zahra and Pearce, 1989).

Team production theory (Kostant, 1999; Blair and Stout, 2001) explains why corporate boards should function as independent arbiters among corporate constituents who have invested in the entity. Boards are designed to play an intervening or mediating role between the enterprise and society and to help resolve competing claims on the corporation (Corbetta and Salvato, 2004; Demb and Neubauer, 1992). Boards thus have a dual role in shaping the corporate life-space as an intermediary between the corporation and three other governance forces: regulation, ownership, and societal pressure (Demb and Neubauer, 1992; Short, Keasey, Wright, and Hull, 1999).

The four board roles presented in this discussion – control, service, strategy and mediation – represent key facets of the board's overall governance role. While a specific orientation or emphasis is indicated with each of the four roles, respectively, in practice the boundaries between each is less distinct. In performing their governance role boards will bring aspects of each role into play depending not only on the requirements placed upon them by the firm's changing circumstances but also the combination of competencies around the board table (Lynall, Golden and Hillman, 2003; Roberts, McNulty and Stiles, 2005).

## **2.2 Board roles in SMEs: A contingency perspective**

In response to a lack of empirical support for single-theory models of boards and firm performance many authors have called for a multi-theoretic approach to research addressing boards and governance (e.g. Daily, Dalton and Cannella, 2003; Lynall et al., 2003; Pye and Camm, 2003; Pye and Pettigrew, 2005) to better understand how boards function in reality and to re-conceptualise board roles. Researchers have been criticised for a tendency to generalise their findings across a population in attempting to find a universal "one-size-fits-all" solution to board effectiveness (Pye and Camm, 2003; Pye and Pettigrew, 2005). Attempts by researchers to fit the world of corporate enterprise into abstract categories that are remote from actual behaviour have also been criticised (Knights and Willmott, 1993; Mintzberg, 1982; Samra-Fredericks, 2000a, 2000b). Lynall et al. (2003) contended that it is not a question of whether existing theories are helpful for understanding boards and firm performance, but rather, when each is helpful.

In this study we combine and integrate a strategic contingency perspective of governance with the portfolio conceptualisation of board roles in our framework. We take into account both external and internal company contexts and consider board roles, similarly, as contextual in nature (Huse, 2005; Strebel, 2004). Such situations may include the institutional context, the industrial sector within which the firm finds itself, the firm ownership context, and its life-cycle stage. Corbetta and Salvato (2004) adopted a contingency perspective in examining board structure, activity, and roles in family businesses. They noted a high degree of heterogeneity in their typology of board composition due to various factors impacting on boards, such as firm mimicry, institutional pressure and internationalisation. Family and business cultures, which shape governance systems, also differ widely across geographical boundaries as well as over time and business life cycle stages (Astrachan, Klein and Smyrnios, 2002; Clarkham, 1994; Corbetta and Salvato, 2004).

From a contingency perspective dynamic boards will adopt and fulfil the roles consistent with the strategic circumstances and requirements of the firm (Hillman et al. 2000; Pfeffer, 1972). The view that board roles change according to firm circumstances (Jonsson 2005; Lynall, et al., 2003) is thus central to our theoretical framework. A particular situation which is often problematic in SME governance concerns the power relationship between the owner-founder/CEO and the board. These dynamics will play out in the actual role played by the board.

### 2.3 Shifts in the balance of power

Hermalin and Weisbach (2003) examined factors that affect board composition and how boards evolve over time. They found that this evolutionary process depends on the bargaining power of the CEO relative to that of the directors. They also noted that boards exist for a variety of reasons besides being the product of regulation, hypothesising that boards are primarily a market solution to an organisational design problem. With regard to board composition Hermalin and Weisbach found that closely-held firms in which the founders remain active and where the CEO has a large ownership position tend to have insider-dominated boards. In contrast larger and older firms are more likely to have professional management with small ownership stakes and outsider-dominated boards. They found that changes in board composition are likely to occur after abnormally poor firm performance or a change in CEO, with inside directors being replaced by outside directors.

Finkelstein (1992) identified several dimensions of power: structural, ownership, expert, and prestige, each of which may be relevant to the extent of their influence on board formation. At the entrepreneurial stage some organisations will seek equity financing and this will often coincide with the formation of a board or a change in board composition. Lynall, et al. (2003) argued that various corporate governance theories will have differential applicability to board formation across different stages of the life cycle, and will also depend on the relative power of the CEO and financier. Social network theory may have greater explanatory power at this stage when the relative power of the CEO/financier will determine whose social network the board reflects. Resource dependency theory, in contrast, helps illuminate board composition in the intermediate stages of collectivity and cooperation and the formalisation and control stages of the firm’s life cycle, when CEOs have dominant power. On the other hand, institutional theory will be particularly applicable to board formation at the formalisation stage when CEOs have relatively strong power, while agency theory will be more illuminating at the formalisation and control stage (Lynall et al., 2003).

### 3. Methodology

Case studies were conducted among six Tunisian SMEs. The main characteristics of the case-firms are presented in Table 3. Data was gathered primarily from interviews, and also from other sources including company and legal documents, company reports and publications, director networks, and media material. A total of 26 semi-structured interviews were conducted between 2011 and 2012 with at least three directors from each firm, including the CEO/owner. Interviews lasted between 30 minutes and an hour-and-a-half, yielding more than 20 hours of audio-recorded and transcribed material. Most of the interviews were conducted in French, with some in English and Arabic and then translated into French. Transcribed interviews were categorised by theme according to the different tasks associated with each board role derived from the literature review (Bardin, 1977, Miles et al., 2005) (see Table 2).

**Table 2:** Tasks defining board roles from literature review

| Board Activities                                | Authors                         |
|---|---------------------------------|
| Control Role Activities                         |                                 |
| Select executives                               | Pearce and Zahra (1992)         |
| Monitor, assess, reward executives              |                                 |
| Protect shareholders’ interests                 |                                 |
| Monitor financial statements                    | Finkelstein and Hambrick (1996) |
| Monitor managers (hiring, firing, remuneration) | Johnson et al. (1996)           |
| Approve managers’ decisions                     | Hillman et al. (2000)           |
| Control strategy implementation                 |                                 |
| Plan CEO’s succession                           |                                 |
| Assess and compensate CEOs                      |                                 |
| Strategy Role Activities                        |                                 |
| Define the business model                       | Pearce and Zahra (1992)         |
| Define firm’s mission                           |                                 |
| Decide and implement strategy                   |                                 |
| Service Role Activities                         |                                 |
| Advice on technical element                     | Whisler (1988)                  |
| Advise CEO and managers                         | Johnson et al. (1996)           |
| Represent firm’s interest                       | Pearce and Zahra (1992)         |
| Link to firm’s environment                      |                                 |
| Expand network for resources                    | Finkelstein and Hambrick (1996) |

| Board Activities                               | Authors                        |
|--|--------------------------------|
| Mediation Role Activities                      |                                |
| Build, maintain and work for actors' consensus | Kim, Burns and Prescott (2009) |
| Reconcile conflicting positions                |                                |
| Balance stakeholders' interests                | Vandewaerde et al. (2010)      |

The primary board role for each firm was established by counting the number of references made by the firm's interviewees to tasks within the role categories.

#### 4. Results

The main characteristics for the six case companies are presented in Table 3.

**Table 3:** Case company characteristics

| Company | Company Type       | Industry                            | Ownership Type (Shares) | Founder as CEO | Company Size (Staff) | Company Established (Age - Years) | Annual Av. Revenue (€ M) | Board Size | Board Composition                    | Board Meeting Frequency (per year) |
|---------|--------------------|-------------------------------------|-------------------------|----------------|----------------------|-----------------------------------|--------------------------|------------|--------------------------------------|------------------------------------|
| TI      | Non-Public         | IT solutions                        | 99% (CEO)               | Yes            | 49                   | 1987 (35)                         | 7                        | 9          | 6 Family<br>3 Outside                | 2-4                                |
| SW      | Private Subsidiary | Construction material merchandising | 99% (Family)            | No             | 14                   | 2009 (5)                          | 1.2                      | 7          | 3 Family<br>4 Outside                | 4 + informal preparatory           |
| SD      | Non-Public         | Pharmaceutical                      | 51% (founder)           | Yes            |                      | 1990 (25)                         | 2                        | 12         | 3 Family<br>6 Friends                | 2-4                                |
| IN      | Non-Public         | Plastic extrusion and profiling     | 93% (Family)            | Yes            | 268                  | 1972 (42)                         | 12.5                     | 7          | 6 Family<br>1 Friend                 | 1                                  |
| ED      | Non-Public         | Real Estate                         | 51% (Family)            | No             | 100                  | 2002 (12)                         | 4                        | 6          | 2 Family<br>5 Outside                | 3-4                                |
| AB      | Listed (2005)      | Automobile parts production         | 61% (Family)            | No             | 600+                 | 1938 (76)                         | 30                       | 10         | 7 Family/<br>Affiliated<br>3 Outside | 4 + informal preparatory           |

The following discussion describes briefly the board dynamics in the six cases.

##### 4.1 Case TI

The board of nine directors comprises six family members, three being the CEO's wife and two daughters, and three outside directors. The board is led by the CEO/founder. Rather than involving the board in decision-making, and especially strategic decisions, the CEO looks outside the firm for advice and consultancy. The CEO trusts only one of the outside directors who shares the same engineering school background, despite other board members being professionally qualified (in management and engineering). While the CEO regards director competences as important, there is no apparent awareness of the diversity of directors' skills on the board nor acknowledgement of the strategic contribution that a board may make. To the CEO, having a board is simply a formality.

The CEO is in a central and hegemonic position. The board of directors has undergone a transformation over the years. Two major periods characterize the board dynamism. The first depicts a dispersed ownership with one main financial institutional shareholder.

The change in the composition of TI's board has led to a shift of power from shareholders and directors to the CEO. The company uses a dual statutory audit, the first in accordance with the Commercial Code and the second informally. The move to this format has eliminated the involvement of the board in its oversight role so that over the years it has become passive and the CEO regards the directors as "irrelevant". Conversely, the directors believe their board to be active, serving strategic and service roles. The board has been retained but functions as a "rubber stamp" (Huse, 2007; Kosnki, 1987), ratifying strategic decisions made by the CEO.

#### **4.2 Case SW**

The company is a subsidiary of a large private group of about 50 companies in different sectors including banking, insurance, leasing, tourism, trade, industry, and health. Since the SME's inception the board has played a very active role. This can be explained mainly by the recruitment policy for directors based on skill and experience and while still at an early development stage, the company continues to evolve strategically by intention toward sustainable profitability. The CEO/owner has deliberately constituted a board of directors with expertise and experience. The board is perceived by the CEO and its directors as an active advisory board playing all four roles, with substantial emphasis on strategic decisions for the business.

#### **4.3 Case SD**

The board's 12 directors comprise two family members and the remainder are friends/affiliates. The board meets as determined by the CEO/chairman, between two to four times per year. Board meetings last four to five hours and while there is substantial discussion, which often strays into management, most decisions are made outside formal board meetings. The board is dominated by the CEO/chairman who makes all strategic decisions. The board's focus is on control and surveillance and, to the CEO/chairman, has no useful strategic contribution to make to the firm, serving as a rubber stamp for his decisions.

While limited by the CEO/Chairman's dominance, the other directors see the board's role as service and strategy, serving as care-giver and controller. The directors believe they serve to challenge the CEO/chairman's assumptions and often narrowly-focused position.

#### **4.4 Case IN**

Six of the board's seven directors are family members qualified in engineering, finance or economics. The two requirements for a director on this firm's board are family relationship and experience, with the firm's management required to be in the hands of the family. While the board meets officially once a year, the justification is that because the directors are almost all family members and are involved in the company on a daily basis, formal meetings to discuss strategic and operational issues are superfluous.

Decision-making rests with four family members who are the key advisors, three of whom are directors including the CEO, the founder and the chairman. To these three directors who control and manage the company, the rest of the board is seen as ineffectual and decisions are made outside formal board meetings. The collective group is important, however, especially for mediation of conflict among family board members. For this board the three dominant directors at the apex play all four roles but act primarily in a pilot role, while the remainder of the board acts as a rubber stamp.

#### **4.5 Case ED**

Of the six directors only one is a family member who owns a majority (51%) of the shares, the rest being dispersed. The board meets three to four times a year for two to three hours. While the CEO would prefer a greater frequency of formal meetings for important discussions, friendship ties developed over time among the directors mean that these meetings are informal.

Board composition is based on skills diversity rather than family links and the directors have widely different backgrounds and sector experience, including audit, car sales, financial broking, archival, engineering, textile,

and farming. The focus on diversity in director selection facilitates a primary advising, consultative role that supports management, while financial control is delegated to the managers so that board energy can be focused on strategic issues. The board is seen as a forum, a source of decision input and information sharing, and a decision-making unit for development of new strategic horizons for the company. While it also acts to mediate stakeholder conflict over key strategic decisions, as well as performing in the strategy and control roles, the board sees itself in a service role providing moral, logistical and financial support.

#### 4.6 Case AB

The 10 member board comprises seven family or affiliated directors and three outside directors. The main selection criteria for external directors are experience, skills and diversity of ideas. While the board meets quarterly, “preparatory meetings” allow greater information exchange and interaction among directors. Board meetings focus on strategy, company development and decision making processes, as well as monitoring and approving the financial accounts.

The board is seen as not only useful but also essential, playing a crucial role in the company. While the founder remains a key board member respected for his expertise and experience, a democratic leadership style predominates.

Having transitioned from primarily a monitoring board where key decisions were made by a small core group, to a fully active, competent, well-functioning and effective board of directors acting primarily in the strategic and service roles, this transformation is reflected in the company’s development and its financial performance. The board’s role transition during the IPO phase also required it to act as mediator reconciling and balancing family shareholding and company interests.

### 5. Discussion and conclusion

Our findings shed light on the complexity of SME board roles which cannot be explained adequately by a single theory independently from organisational context and value creation (Huse, 2000, 2005, 2007). Compared with Fama and Jensen (1983) who claimed that boards could exist without adding value to the firm, our results (summarised in Table 4) show that even supposedly passive boards play a valid role.

**Table 4:** Board role attributes

| Board Attributes                           | TI                                  | SW  | SD                   | IN                            | ED  | AB   |
|--|-------------------------------------|---|----------------------|-------------------------------|---|--|
| Impact on firm                             | No                                  | Yes   | Indirect             | Indirect                      | Yes   | Yes  |
| Efficiency                                 | No                                  | Yes   | Yes                  | Yes                           | Yes   | Yes  |
| Board Dynamism                             | Passive                             | Active  | Passive              | Passive                       | Active  | Active   |
| Convergence in Directors’ Role Perceptions | No                                  | Yes   | No                   | No                            | Yes   | Yes  |
| CEO hegemony                               | Imposed and accepted                | No  | Imposed and accepted | Perceived                     | Perceived   | Perceived  |
| Leadership                                 | Authoritarian                       | Democratic  | Authoritarian        | Authoritarian                 | Democratic  | Democratic   |
| Roles                                      | Discussion of strategic orientation | All four roles with primary emphasis on <i>service</i> role | Focus on control     | Focus on control and strategy | All four roles with primary emphasis on <i>service</i> role | All four roles with primary emphasis on <i>strategic</i> and <i>service</i> role |

Board roles in the case companies examined in this study are shown to be varied and emerge from company circumstances. For these firms the board's roles are based on decisions taken by individual directors (e.g. dominant CEOs or founder- directors) and imposed on the board or made collectively by the board as a whole. Board members in the case firms have certain expectations about the board's tasks and its role. These

expectations may or may not be in alignment with those of the CEO/founder. Nevertheless, the board has an impact, direct or indirect, on the firm's performance. Boards which seem to play only a rubber stamping role are still valued for advice, debate, mediation and challenging the CEO/founder. As such, the notion of the board as a legal fiction (Demb and Neubauer, 1992) is misleading. Moreover, the idea of the pilot board as being fully engaged in all of the board tasks is also somewhat misleading for SMEs. When the CEO/founder dominates the strategic decision making process, the board, while an active and key participant, plays a lesser role than theory suggests for the fully engaged pilot board. Our findings suggest that due to SME heterogeneity, firm dynamism and circumstantial contingencies, board roles will vary among the four main role types and will exhibit different task emphases depending on the stage in the firm's development, the ownership structure and the relationship between the CEO/founder and the board.

Our results show that where leadership is democratic and power is shared between the CEO/founder and the board, all four roles are played but with an emphasis on a particular role or roles. These boards' contribution appears to be the most valued and to have the greatest influence on the firm. Directors in these three firms are selected for their competencies – whether or not they are family members or affiliates – acting to complement the CEO/founder's vision, drive and expertise. We have argued that effective leadership will be commensurate with an appropriate shift in the balance of power from management to the board as the firm evolves and becomes more complex in its structure and systems, and when the board understands how it can best make a strategic contribution to the firm. Regardless of the stage in the firm's development, our results suggest that an effective board will play all four roles simultaneously. However, the greatest contribution will be made when emphasis is placed on the type of role and requisite competencies that are consistent with the firm's circumstances and will shift in emphasis as the firm evolves. The three firms whose boards most closely demonstrate the portfolio concept of roles have adapted over time and appear to function more effectively than those in firms with autocratic leadership styles and limited board roles. While more work is required to confirm and validate our framework, our study provides encouraging initial support for the portfolio concept which more adequately explains and captures the role and purpose of a board in the SME context.

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