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**Changes in Expectations to Internal Corporate Governance
Mechanisms in the Company Raising Capital in Its Start
Phase: Case Study of Milrem AS**

Master's thesis

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Allowed for defence

(signature of supervisor)

I have written this master's thesis independently. All viewpoints of other authors, literary sources and data from elsewhere used for writing this paper have been referenced.

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(signature of author)

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INTRODUCTION

Companies are legal constructions that play an important part in modern economies. They contribute to and are influenced by the economies and societies within which they exist and operate. Corporate governance has been part of research into business profession since Adam Smith's (1776) seminal publication of *An inquiry into the Causes of the Wealth and Nations* (Tirole 2001: 1) and undoubtedly given impetus through Berle and Means's (1932) classic publication of the separation of corporate ownership and control (Aguilera *et al.* 2016: 172). Corporate governance is aimed at reducing conflicts of interest and moral hazard risk. Good corporate governance can also be considered as the diligent way in which providers of corporate financial capital guarantee appropriate rewards in a legal and ethically moral way.

The seminal publication of Jensen and Meckling (1976) initiated an unprecedented increase in corporate governance research over four decades ago. Scholars have researched corporate governance mostly in developed countries building their studies on the US and the UK evidence. Lehmann (2019: 29) has concluded that corporate governance approach is almost always based on the archetype of public corporation with dispersed shareholder structure. The approach taken so far holds for small amount of large mostly listed companies, while smaller private companies have been less the subjects of the research. Relatively little research has been done in the field of corporate governance changes along the different stages of corporate life cycle (O'Connor, Byrne 2015: 24). Significant amount of companies passes the start phase of their life cycle and do their first capital raising. The expectations to corporate governance mechanisms at early stages of companies have not been properly researched, which opens promising research gaps in the literature. While the research questions remain the same, the scope and field of application varies.

Corporate governance topic has been little researched and covered in Estonia. According to the author's knowledge there seems to be no academic research conducted on corporate governance mechanisms changes in the start phase of Estonian firms. The current master's thesis wishes to fill that gap by exploring the mechanisms applied in the start phase of the company within its life cycle. As the current master's thesis is the first to cover this area, it focuses on the general understanding of the expectations to internal corporate governance mechanisms, which increases the awareness of the topic in Estonia and hopefully improves the governance quality. It also builds the basis for further research area in internal and external mechanisms of governance for Estonian companies.

The aim of the master's thesis is to identify how the expectations to internal corporate governance mechanisms are changing in the company, which is in the start phase of its corporate life cycle at the moment when the company belonging to its founding shareholder(s) raises capital. The following research questions were set in order to achieve the aim:

- 1) define the term "corporate governance";
- 2) provide overview of the main theories in the framework of corporate governance and internal mechanisms based on theoretical literature;
- 3) provide overview of how the expectations to internal corporate governance mechanisms are changing in the start phase of the corporate life cycle based on theoretical literature;
- 4) identify the cause of corporate governance problem in the case study company;
- 5) collect data from multiple sources of evidence about the expectations to internal corporate governance mechanisms;
- 6) analyse how the expectations to internal corporate governance mechanisms are changing in the company, which is in the start phase of its corporate life cycle at the moment when the company belonging to its founding shareholder(s) raises capital and compare it with the findings of prior literature.

The thesis is divided into theoretical and empirical chapters. The first section in theoretical chapter creates the relevant context for understanding corporate governance by analysing definitions and synthesising different treatments to acceptable level, which enables understanding the governance problems. Organisational theories are covered to

explain the objectives and internal mechanisms to respond those problems in the second section. The third section explains corporate life cycle stages and illustrates how the expectations towards internal corporate governance mechanisms are changing in the start phase of the life cycle. Theoretical framework is based on research papers, where the notable authors are Ruth V. Aguilera, Igor Filatotchev, Michael C. Jensen, William H. Meckling, Jeffrey Pfeffer and Gerald R. Salancik. At the end of the theoretical chapter the author has compiled the model, which summarises the covered theoretical part that can be used for addressing to the governance problems in practical way.

Empirical part has been divided into two sections. The first introduces the research methodology and argues the basis for selecting the methods and techniques. The second part analyses the research results and provides synthesis with the key facts from the theory and prior studies.

The author believes that the master's thesis is valuable at least to three target groups. Firstly, being the first research about how the expectations to internal corporate governance mechanisms are changing in the start phase of the company in its life cycle, it builds further research areas and framework among scholars and students in that field, which can be further expanded to individual or bundles of internal and external mechanisms. Secondly, the analysis might be interesting and valuable for founders of the company, who are managing the firms at their start phase of their life cycle and planning to raise or have raised capital from new investors. The master's thesis gives an overview of the corporate governance goals, mechanisms and functions, which raises the awareness, hopefully results into improved governance and higher quality of management processes and decisions in the companies. It explains investors' expectations to corporate governance, their aims, opportunities, restrictions and considerations when investing into the company. Thirdly, investors will understand better the behaviour and thinking process of the founders, when discussing governance issues during the negotiations of capital injection into the company and gives the framework that can be used while explaining and reasoning their expectations to the founders of the company. Tuschke and Sander (2003: 646) have concluded that good corporate governance reduces the cost of monitoring and auditing by helping companies to efficiently reduce their costs. According to La Porta *et al.* (2000: 14) better corporate governance practices lead to a higher cash

flow for shareholders. Both of these conclusions support the increased efficiency and higher cash flows in the company, which essentially creates higher value for the shareholders.

Keywords: corporate governance, start phase firms, internal corporate governance mechanisms, moral hazard, start-ups.

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Management of enterprises

1. THEORETICAL FRAMEWORK ON CHANGES IN INTERNAL CORPORATE GOVERNANCE MECHANISMS

1.1. Definition of Corporate Governance

Corporate governance is becoming more and more popular topic from different perspectives such as regulators, professional bodies in business and academic research. There are several definitions for corporate governance. Debate about the precise definition is still ongoing and it is difficult to define the concept in a universally acceptable way. Mulili and Wong (2011: 14) have cited Ramon (2001) that differences in terms of culture, legal systems and historical developments across the countries make it difficult to identify one definition of corporate governance. The basis for the concept has grown out from the shareholder perspective where the primary focus was safeguarding the company's assets. Over the time the focus has shifted to broader stakeholder perspective similarly to redefining the purpose of the corporation by large US companies where the commitment to shareholders has shifted to the commitment to stakeholders by delivering value to customers, investing into employees, dealing fairly and ethically with suppliers, supporting communities in the field of business and creating long-term value for shareholders (Business Roundtable ... 2020).

This concept has been also referred in research papers as the narrow view and the broad view (Olayiwola 2010: 178). Maher and Andersson (2000: 8) state that narrow standpoint of corporate governance often describes the formal system of accountability of senior management to shareholders with the aims to maximise and protect the shareholder, while from the broader viewpoint, the corporation is responsible for a wider constituency of stakeholders other than shareholders.

Zingales (1997: 4) has distinguished the narrow and the organisational viewpoint of corporate governance. The narrow viewpoint takes shareholders' perspective with the

motivation of maximising the value of their investment, while the organisational perspective explains how controlling mechanisms maintain and regulate business operations. Shleifer and Vishny (1997: 737) define corporate governance in terms of the ways in which suppliers of finance to corporations assure themselves of a good return to their investment, which is very similar to La Porta *et al.* (2000: 4) reference “set of mechanisms through which outside investors protect themselves against expropriation by the insiders”. The abovementioned definitions are consistent with the views that the main obligation of a company is towards maximising the wealth of its shareholders.

However, alternatively much of attention has been paid also to the fact that corporate governance is not only about holding management accountable – and thus minimising downside risks to shareholders – but also about enabling management to exercise enterprise in order to assure that shareholders benefit from the upside potential of firms (Filatotchev *et al.* 2006: 257). This definition is broadly in line also with the concept of G20/OECD principles, where the OECD (2015: 9) defines corporate governance as: “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders”. The corporate governance specifies the responsibilities and rights between the parties and sets the rules and procedures for decision-making in the firm. Such parties include the board of directors, management and shareholders. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance (OECD 1999: 9), in other words “the system by which companies are directed and controlled” (Cadbury 1992: 15).

Based on the recent literature review of various definitions of corporate governance that have been produced gives even further complexity. Rezaee (2019: 66) describes corporate governance as an ongoing process of managing, controlling and assessing business affairs to create shareholder value and protect the interests of other stakeholders. According to this definition, there are seven important functions of corporate governance: oversight, managerial, compliance, internal audit, advisory, external audit and monitoring. Mallin (2019: 10) has listed essential features of corporate governance as follows: it assists in ensuring that an adequate and appropriate system of controls operates within a company and that assets may therefore be safeguarded; it avoids any single individual having too

much influence; and it tries to encourage both transparency and accountability in the relationship between company management, the board of directors and other stakeholders, which investors are increasingly looking for in both corporate management and corporate performance.

In Estonia emphasis on the importance of corporate governance has increased over the recent years. According to the author's knowledge the fundamental questions and the purpose has not been properly explained. There are references in the Estonian Accounting Act, which refers to the requirements of preparing and disclosing corporate governance report for certain entities. The underlying requirements are published by the Estonian Financial Supervision and Resolution Authority as Corporate Governance Recommendations. However, none of two sources referred to above do not give any definition of the corporate governance. According to the author's opinion these are descriptive regulations, which do not explain the corporate governance framework and leave the gap in understanding the proper purpose of adopting individual regulated items to comply with the laws and regulations.

Taking the above into account, it becomes predictable that the variations between the definitions illuminate different perspective taken by the authors. Table 1 summarises the definitions. The absence of a common accepted definition has negative implications as it can influence the focus and interpretation. In this master's thesis, the author defines corporate governance based most frequently used Cadbury Report and OECD definitions (Nerantzidis *et al.* 2012: 15) by shortening originals and emphasising more on the mechanisms and processes to achieve well-functioning governance structure as follows: 'Corporate governance is the set of mechanisms, processes and relations by which corporations are controlled and directed'.

According to Rajan and Zingales (2000: 201-202) the fundamental issue in corporate governance is how the "surplus that accumulated at the top of the organizational pyramid could be prized out from the sticky fingers of top management and given to the rightful owners, the dispersed shareholder". In the research literature, there are references as efficiency of operations, reliability of financial reporting, compliance, etc. to be included in corporate governance problems. It is the author's belief that including wide area of

potential business-related problems as subject matter in this field, it just opens the new avenue with debateable framework that cannot be properly justified.

Table 1. Corporate Governance Definition by Authors

Definition Source	Definition
Cadbury Report, 1992	The system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.
Shleifer and Vishny, 1997	Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.
Zingales, 1997	The complex set of constraints that shape the ex-post bargaining over the quasi-rents generated in the course of a relationship.
OECD, 1999	Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.
La Porta <i>et al.</i> 2000	A set of mechanisms through which outside investors protect themselves against expropriation by the insiders.
Rezaee, 2019	Well-balanced corporate governance functions can produce effective corporate governance, investor protections, reliable financial reports, credible audit and assurance services, and sustainable business.

Source: Compiled by the author

Author of the master's thesis has concluded that various scholars have explained corporate governance problems from individual angles, which might have been caused also by not having the consensus about the definition and clearly defined framework. Firstly, taking the aspect of 'conflict of interest' the content of this will be more elaborated in the next section of the thesis in explaining the agency theory. Roe (2004: 2) has not distinguished different problems but refers that it has a both vertical and horizontal dimensions. Author of the master's thesis emphasises that this statement should be dealt together with the 'conflicts of interest' problem. The vertical aspect is especially relevant in corporations with dispersed ownership as the problems are arising between senior managers and shareholders and its focus is on keeping the senior management loyal to shareholders as well as competent enough for the goals of the firm's management. The horizontal aspect of the corporate governance problem occurs between dominant and dispersed shareholders and its focus is on preventing the shifts in value from dispersed to

dominant or controlling shareholders. The two aspects of the corporate governance problem share one similar characteristic – in each, the other party may private benefit at the cost of remaining shareholders. In vertical dimension the managers may benefit at the cost of shareholders and in horizontal dimension the majority shareholder may benefit at the cost of minority shareholders.

In addition to horizontal and vertical dimensions the second major problem in governance is ‘moral hazard’ problem. It occurs when an individual has an incentive to increase their exposure to risk because they do not bear the full costs of that risk (Macey 2008: 24). Moral hazard in the context of this master’s thesis refers to the problem that in order to build success in the company, the management takes risks where it has less to lose compared to the shareholders. Moral hazard occurs under a type of information asymmetry where the risk-taking party to a transaction knows more about its intentions than the party paying the consequences of the risk and has a tendency or incentive to take too much risk from the perspective of the party with less information. In order to reduce the risks related to conflicts of interest and moral hazard problems the author covers the main theories in the framework of corporate governance, internal mechanisms and expectation changes to those mechanisms in the next section of the thesis.

1.2. Theories and Internal Mechanisms in the Framework of Corporate Governance

In reviewing research papers author faced confusing treatments, where ‘corporate governance theory’ was explained building the argumentation on agency theory, etc. In many cases there was no clear distinction made that ‘corporate governance theory’ *per se* is explained by organisational theories to argue viewpoints and effect of governance mechanisms. Much of the weight in solving governance problems within corporations has been assigned to the board of directors and to the need of non-executive directors (Aguilera 2005: S40). The relationship to other corporate institutions is central to understand the theories. According to the author’s opinion the term ‘board of directors’ should be carefully explained as scholars tend to refer to this institution without distinguishing whether one-tier or two-tier board model is discussed. Depending on the context, building governance mechanisms to address problems could lead to wrong conclusions. Figure 1 summarises the differences between board models.

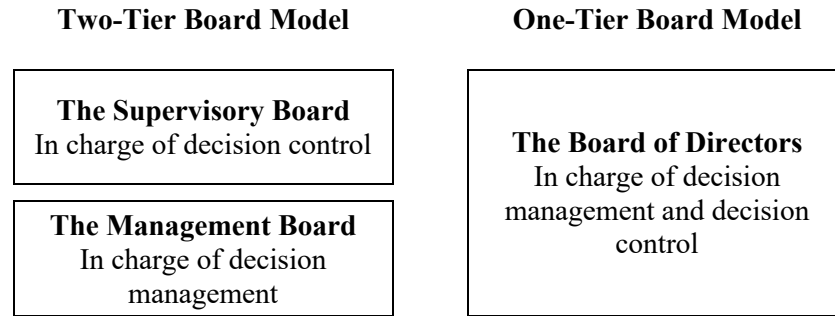


Figure 1. Differences between two- and one-tier board models (compiled by the author).

For two-tier model the decision management is delegated to the managing directors in the executive management board. Decision control lies in the hands of the non-executive directors in the supervisory board. One-tier boards are formally based on a structure that combines decision management with decision control. One-tier boards could have also non-executive directors, who are the members of the board, but not part of the executive team. According to the author's understanding the 'board of directors' and 'non-executive directors' in the literature are mostly referred to one-tier board model.

Nicholson and Kiel (2007: 585) have concluded three main theories relevant to explain corporate governance are agency, stewardship and resource dependency theory. From the literature review corporate governance is explained also by institutional, team building, managerial hegemony and many other theories, which have not been that widely covered as the first three ones. For the purpose of explaining governance mechanisms the author has narrowed the number of theories down to three most widely used ones: agency, stewardship and resource dependency theory.

All three theories describing organisational behaviour emphasise on the importance of shareholders' wealth. Brief summary of the theories on each key assumption and the board of directors' role and function are presented in Table 2. Agency theory suggests that shareholders' wealth should be protected while shareholders and managers might have different interests. Stewardship theory indicates that similar interests of managers and shareholders will lead to higher firm value. Resource dependency theory proposes that management requires wider access to resources in order to perform.

Table 2. Summary of Organisational Theories

Theory	Assumption	Board member role	Board main function
Agency theory ¹	Owners' interest may differ from managers' interest	Supervisor / Managerial control	Conformance: <ul style="list-style-type: none"> • Safeguard owners' resources and interests • Supervise management
Stewardship theory ²	Owners and managers have similar interests	Partner / Managerial empowerment	Improving performance: <ul style="list-style-type: none"> • Add value to top decisions • Partner management
Resource dependency theory ³	Organisational survival depends on maintaining coalition of support to obtain resources and legitimacy	Supporter / Search for external resources	External influence: <ul style="list-style-type: none"> • Secure resources • Improve stakeholder relations • Bring external perspective

Source: (¹Jensen and Meckling, 1976; ²Donaldson and Davis, 1991; ³Pfeffer and Salanick, 1978), compiled by the author

According to the author's opinion, the difference between assumptions and functions of these theories make them confusing, especially the difference between agency theory and stewardship theory, where agency theory suggests that owners and managers have different interests while stewardship theory states the opposite. In the following brief summary of each theory is explained.

Agency Theory. Empirical research on corporate governance has been rooted in agency theory where governance mechanisms ensure the alignment of the interests of the owner (principal) and the manager (agent). The theory was introduced by Jensen and Meckling in 1976, where they defined principal-agent relationship, in which principals hire agents to run the firm in the best interests of the shareholders, while the managers are rewarded for their effort (Jensen, Meckling 1976: 309). According to Jensen and Meckling (*Ibid.*: 309) the performance and outcome depend on the extent of the agent's efforts and the risks involved, but the efforts of the agent are not fully observable to the principal. Therefore, information asymmetry makes it difficult for the principal to measure the efforts made by and to correspondingly compensate the agent, which implies greater reward for the risk-averse agent due to less incentive to make effort (Sappington 1991: 51). Agency theory states that due to the asymmetric information distribution between

shareholders and managers, it is difficult for owners to measure the performance of managers who are more knowledgeable of the operations of the company.

The agency theory relies on the assumption that conflicts of interest arise in corporate relationships due to the divergence of the interests of managers and shareholders. Core assumptions of agency theory are that managers may maximise their own benefit instead of enhancing shareholder value (Jensen, Meckling 1976: 309) and that contracts are not costless when writing and enforcing (Fama, Jensen 1983b: 327).

Addressing corporate governance problems as covered earlier through agency theory is relevant and most used in the literature. Managing conflicts of interest and moral hazard problems incur agency costs. These include monitoring costs, bonding costs and residual losses (Jensen, Meckling 1976: 309). Monitoring costs include the costs for monitoring the conduct of managers by shareholders. Costs relating to set up systems and structures intended to ensure that managers act in the best interests of the shareholders, or compensate them accordingly if they do not, have been defined by Jensen and Meckling (1976: 309) as bonding costs. Residual losses occur due to the mismatch of actions despite monitoring and bonding activities. Fama and Jensen (1983b: 327) stated that residual loss is the value of profit lost because the contract's full enforcement costs exceed its benefits.

Stewardship Theory. According to Muth and Donaldson (1998: 5) stewardship theory is the second major theory of organisation behaviour that provides an alternative perspective to agency theory. Whereas agency theory assumes the conflicts of interest and divergent relationship between the priorities of shareholders and the actions of managers, stewardship theory presents a more collaborative perspective. Emerging from the psychology and sociology literatures (Muth, Donaldson 1998: 5), stewardship theory describes a convergent relationship between company shareholders and management.

The theory focuses on psychological and sociological methods of oversight. Stewardship theory assumes that organisational members have positive collective identity that engenders trustworthy behaviour and agree in that financial gain is not necessarily the sole driver of managerial behaviour (Davis *et al.* 1997: 24). Stewardship theory argues that concern for managers for their own reputation prevent managers from acting against the interests of shareholders.

Separate ownership is not viewed as a weakness in stewardship theory. Zahra and Pearce (1989: 309) have argued prior the introduction of stewardship theory in 1991 that there is a mixture of the interests of individuals and organisations with the aim of achieving maximum performance and the trade-off for self-interest does not exist because of the consistency in benefits of both managers and shareholders. Donaldson and Davis (1991: 51), conclude that managers are thought to be interested in obtaining high performance and using their power to act in the interests of shareholders. Thus, they have many different behaviours and reasons beyond self-interest, which explains why the contradictory objectives do not exist in the separation of ownership from control. In these situations, controls would not be the solution to help improving firm's performance or protecting shareholders' interests. According to stewardship theory, which focuses on psychological factors, managers are expected to perform better with greater empowerment.

In addition to the fundamental difference in the assumption towards the organisation functioning as described above, the author has concluded also another considerable difference between agency theory and stewardship theory. Agency theory uses market value to measure extrinsic satisfaction while the stewardship theory concerns with intrinsic satisfaction achievement. It is believed that the interests of the managers could be met if they act for the benefits of shareholders in order to achieve high performance and argue that shareholders could gain maximum profit when control is conducted effectively by management (Zahra, Pearce 1989: 309). As the managers are more knowledgeable of operations in companies, it is assumed that their decisions are better informed, which has been built on the one-tier board of directors' model where the decisions and control are presumed to contribute to greater effectiveness.

Resource Dependency Theory. The third major theory of board-management interaction is resource dependency theory, which became widely accepted in Anglo-American discussion. This theory suggests that the board has an important role beyond monitoring and controlling the performance of management (the agency view) or empowering their success (the stewardship view). It argues that the long-term commercial success of a company is dependent on the ability of the directors to organise resources by facilitating connections with external parties (Zahra, Pearce 1989: 298). The purpose of such external

connections is to secure important resources that may not be otherwise accessible by management alone.

Resource dependence theory focuses less to the organisation structure and puts more emphasis primarily on the company's access to resources, such as expertise and capital. Haniffa and Cooke (2007: 589) referred that according to resource dependence theory the board of directors opens firms' access to resources essential for firm performance. The theory particularly favours boards with a high composition of non-executive directors (the term defined above while explaining the differences between two-tier and one-tier board models), as they have wide expertise and knowledge, which improves networking with the external environment. Haniffa and Cooke (*Ibid.*: 589) see that non-executive directors improve also the reputation of the company, networking with external stakeholders, including customers, governments and other companies. Non-executive directors open access to the political and business contacts, capital and information (Nicholson, Kiel 2007: 589). According to the theory the author has concluded that non-executive directors improve access to resources, which results to cheaper access to inputs and therefore affects positively company's performance.

Non-executive directors in the board of directors have important attributes in satisfying the needs for the resource and managing the environment contingency. For example, to open access to financial markets, companies could nominate members from the financial institutions to the board of directors.

According to resource dependence theory non-executive directors are selected according to their skillset and network to gain access to missing resources. Therefore, it is essential to identify companies' dependencies from the board composition. Company's value is expected to increase when it has wider access to resources when the board of directors consists of the members with large network. This is driven by greater networking value with the external environment.

Similarly, with defining the problems of corporate governance, the author found that the objectives of the governance are often undefined. Academic literature has extensively covered meta-analysis of different elements in the framework, which to the author's opinion are dealing with the various characteristics of governance mechanisms.

Therefore, in this master's thesis clear distinction has been made between the objectives and mechanisms, as the latter ones provide solutions in the framework of the first ones. Author believes that the objectives have evolved over the time in connection with the development of the theories that explain corporate governance and also how the purpose of the business has been understood. From purely increasing shareholder's value focus, companies are emphasising more on the wider goals as discussed in the introduction chapter. Effiong *et al.* (2012: 111) refer that achieving good corporate governance requires a system of structured operation and control to meet the need of stakeholders through the following objectives:

- achieve a long-term strategy of goals of the owner to maximise shareholder value or control market share;
- secure the interests of employees at all times and ensure that they are guaranteed a positive working atmosphere, further training courses, health coverage and fair retirement packages;
- maintain excellent long-term relations with customers and suppliers in terms of service, quality and financial settlement procedures;
- comply with all relevant legal and regulatory requirements.

In the author's opinion these objectives are too descriptive and analogous to defining core values for strategic management of the company. For example, the last item (comply with all relevant legal and regulatory requirements) cannot be properly framed in the context while looking at the mechanisms, which should serve these objectives. Aguilera *et al.* (2015: 500) have defined in their research four governance objectives, which to the author's opinion fill properly the gap between the problems and mechanisms: 1) protect stakeholder rights; 2) manage stakeholder relations; 3) provide information disclosure; and 4) offer strategic and ethical guidance. Limiting the scope based on the aim of the study, the thesis provides explanation about the internal governance mechanisms that are serving the objectives defined above narrowed down to shareholder level instead of covering wide stakeholder view.

Corporate governance involves a set of mechanisms to support achieving company's goals and objectives by mitigating conflicts of interest and moral hazard problems as

discussed above. Aguilera *et al.* (2008: 475) have worded this goal as mechanisms need to ensure that managers respect the rights and interests of company's shareholders.

Mechanisms for corporate governance should be firstly divided into two parts: internal and external mechanisms (Roe 2004: 6). Distinction between internal and external mechanisms was also covered in Walsh and Seward's research paper (1990: 421) where they defined that internal governance mechanisms refer to the structural components that serve to mitigate mostly the principal-agent problem, while external corporate governance mechanisms refer to market based elements, mostly to market for corporate control. In the author's opinion scholars have relatively freely defined the mechanism, which could lead to the impression that any problem-solving tool might be considered as governance mechanism. Therefore, the author has compiled the list of mostly referred and studied mechanisms and explains them in the following paragraphs.

Internal mechanisms have historically focused on three mechanisms: board of directors (Walsh, Seward 1990: 423), managerial incentives (*Ibid.*: 424) and ownership concentration (Shleifer, Vishny 1997: 753). Internal control/audit is sometimes referred as individual mechanism (Banks 2004: 32) or included as an element in previously mentioned board of directors. The attributes under board of directors mechanism are board size (Lehmann 2019: 21), board composition (including one- and two-tier models and chief executive officer (CEO) duality (where in one-tier board model CEO is in charge of decision management and decision control)) and board activity (including meetings and committee work). Ownership concentration refers to the types and composition of shareholders in a corporation and includes attributes such as concentrated ownership, dispersed ownership, family ownership, institutional investors and managerial ownership (Lehmann: 22-24). External governance mechanisms include legal system, market for corporate control, external auditing, rating organisations, stakeholder activism and media (Aguilera *et al.* 2015: 486), which cannot be directly managed by the shareholders or the board. As the external mechanisms are not in the scope of this thesis, they are not discussed in detail. The illustrative summary of mechanisms and objectives covered above is presented in Figure 3 in the end of next section where the author has developed the model for how to address to the governance problem.

In the following the author illustrates the main components in the internal corporate governance mechanisms through the agency theory covered earlier. Starting from the board of directors, agency theory proposes that in the board, non-executive directors play an important role in monitoring and supervising executives, due to the assumption that they are independent and concerned with their own reputations (Fama, Jensen 1983a: 315). Non-executive directors can therefore add value to firms due to their external knowledge and expertise and also to monitoring function (Fama, Jensen 1983a: 315). Agency theory also recommends the separation of the CEO and chairman of the board (CEO duality as explained above) as combining these two roles in one person can result in increasing agency problems by diluting the effectiveness of monitoring the CEO (Jensen 1993: 866). At the same time, stewardship theory indicates that CEO duality will facilitate better the company's decisions. As a result, one of these theories recommends a higher level of control while the other one relies on the board's honesty and loyalty.

Jensen and Meckling (1976: 309) explored the equity ownership attribute of the ownership structure and alignment of the manager's interest with owners. Shleifer and Vishny (1997: 737) separated corporate governance mechanisms into two main systems: large shareholder control systems with high ownership concentration, often referred also as 'insider model' or 'Continental model' and with high degree of dispersion of the ownership, often referred as 'outsider model' or 'Anglo-Saxon model', such as in the USA and the UK (Franks, Mayer 1997: 31). Author allocates this treatment into the ownership concentration under the internal governance mechanisms. The master's thesis is focusing on the case study of the Estonian firm governance, therefore, for better understanding purposes the list of main characteristics for 'Continental model' according to Cuervo (2002: 85) is considered, shortened and adjusted by the author as follows: (1) ownership is concentrated, companies, and families are large shareholders; (2) control is assumed to be exercised by large shareholders; (3) the board has two-tier model; (4) capital markets are relatively illiquid and have limited control ability; (5) there is no active market for control (management does not face hostile takeover bids). Agency theory explains that the new investor who is injecting the capital into the company plays in the role of principal whereby the company is agent. This results into potential corporate governance problems and the ownership structure along with the agreements is the mechanism to mitigate these risks. Shleifer and Vishny (1997: 754) have concluded that

large and controlling shareholders contribute to the mitigation of the agency problems because they have the incentives, motivations and capacity to monitor the managers.

The third widely covered internal mechanism is executive compensation, often referred as management remuneration. Agency theory states that incentives align agent's interest with principals. Jensen and Meckling (1976: 310) have therefore concluded that managerial ownership increases the interests of the shareholders and managers become more aligned.

The literature has extensively covered how the managerial compensation packages are established to align the manager's interests with those of the shareholders. Such packages include basic or cash compensation, long-term incentive plans (share options), benefits, bonus programs, pension plans, and retirement pay. The expectation of how the internal mechanisms are changing in the start phase of the corporate life cycle will be covered in the next section.

1.3. Changes in Expectations to Internal Corporate Governance Mechanisms in the Company in Its Start Phase

Organisations pass through stages during their life cycle, which is also called corporate life cycle stages. Every particular stage could be symbolised by its specific characteristics. There are differences between the stages in terms of decision-making style, structure, organisation strategy and situation (Miller, Friesen 1984: 1161). In the last half century, many models have been developed that explain the corporate life cycle theory. These models differ from each other by mentioning different corporate life cycle stages. While the models have their differences, they mention more or less the same common stages in their own words. Most common one has been identified by Miller and Friesen in 1984. According to them, there are five life cycle stages: Birth, Growth, Maturity, Revival and Decline (Miller, Friesen 1984: 1161). This resonates also to Dickinson (2011: 1974) theory. Connecting views with the corporate governance relation to life cycles, it is necessary to focus also on the initial foundation / birth stage. Many life cycle theories treat decline and revival as one stage.

Regardless of the precise definition of the very early stage of the corporate life cycle, the birth stage is typically simple, dominated by their owners, informal in structure and undifferentiated. In addition, companies are focusing in this stage on innovation and face uncertainty over future growth. Typically, these companies have no standards, existing structure, facilities or internal ideology. In contrast, these companies may have a founding leader, but they have likely no other full-time members. Companies in the growth stage achieve rapid growth. The separation of ownership and control is becoming more common and more procedures are formalised. Managers are getting more decision-making responsibility. Companies in the mature stage are less likely to take on risky or innovative strategies than in the earlier stages. Furthermore, many of the investments are going to protect what has been achieved and the goal of these companies becomes efficient and smooth functioning. The companies in the decline stage suffer from stagnation and low profitability, which is mostly due to lack of innovation and external challenges. Companies in the declining stages often liquidate assets in order to support their operations. Companies in the revival stage have a rising product-market scope and usually face diversification. In addition, there is also importance for more sophisticated planning and control systems.

Throughout the different corporate life cycles the companies are following predictable patterns that are characterised by the different stages of development. As the companies are developing over time, the levels of profitability, financial needs, growth opportunities, the availability of the financial resources and the opacity of information asymmetry also change. Habib and Hasan (2019: 188) have concluded that corporate life cycle has received substantial interest in the finance, accounting and corporate governance literature. There are evidences that suggest that corporate life cycle has considerable effect on financing, corporate investment, asset pricing, pay out decisions (key corporate decisions) and on corporate governance.

Corporate life cycles can be approached specifically focusing on the individual stage or on the transition moment where the company faces change from one life cycle stage to another. All these stages of the company's life cycle exhibit different needs that ought to be reflected in the way the company applies its corporate governance structures. In the context of corporate governance from now onwards the thesis covers the transition

phases, where typical parameters described by corporate governance go through the change and focuses specifically on the start phase as defined in the research questions.

As the development of corporate governance mechanisms is path dependent (Lynall *et al.* 2003: 424), it is essential to understand when the process of transition is taking place. For example, if the governance system is closely linked to the founder team's characteristics and distribution of power within the organisation it may prove difficult to effect changes (Filatotchev, Bishop 2002: 953). Thompson and Wright (1995: 701) conclude in their study that the taking private of a publicly listed corporation through management and leverage buy-outs, it presents a further point in a company's life cycle where corporate governance mechanisms may change. Wright *et al.* (2000: 599) suggest that these buy-outs may require different governance mechanisms than those when the company was public, depending in part on the goals of the buy-out. According to the author's opinion, this illustrates that the companies have different focus on corporate governance elements during different corporate life cycle stages. Furthermore, it also gives the answers that large public firms may not face the same governance challenges as small private firms.

There are not many studies providing quantitative support for the relationship between corporate governance mechanisms and corporate life cycle theory (Harjoto, Hoje 2009: 37). In addition, there are proposals for further research into how board composition and ownership structures evolve over the company's life cycle post listing (Certo 2003: 441). Studies exist that look both quantitatively and qualitatively on several aspects of corporate governance. These studies include Lynall *et al.* (2003), Filatotchev *et al.* (2006), Huse and Zattoni (2008), and Harjoto and Hoje (2009). Out of those, Filatotchev *et al.* (2006) is particularly interesting, as it is assessing the development of corporate governance from a corporate life cycle perspective. In summary, the framework proposes that the company's need of monitoring, resources and strategy depends on the life cycle stage of the firm. Various combinations of these functions are indicative of differences in the application of corporate governance.

The framework proposed by Filatotchev *et al.* (2006) is established around the idea that companies are passing from one corporate life cycle stage to another. Passing through certain thresholds is indicating the transition towards the next phase of the company's life cycle. As presented in Figure 2 below the framework has two dimensions, the first one

being the strategic environment of the firm that can be seen on the vertical axis and to have high or low “velocity”. By velocity Filatotchev *et al.* (2006) refer to the speed at which changes materialise in the operating environment of the company. The second dimension on the horizontal axis deals with corporate governance objectives having two divergent goals, either a) contributing to wealth creation or b) more concerned with wealth protection. Wealth creation relates more to the resource and knowledge theory by claiming that companies need external agents to provide the company with new knowledge in the form of skill and experience. Wealth protection relates more to the classic view of agency theory and the importance of accountability to ensure that external investor’s funds are well managed by the company’s management.

		Governance Objectives	
Strategic Environment	High “Velocity”	Wealth creation <i>Quadrant 1</i> <i>Founder/IPO threshold</i> Governance functions: <ul style="list-style-type: none"> • Monitoring: low • Resource: high • Strategy: high 	Wealth protection <i>Quadrant 2</i> <i>IPO/maturity threshold</i> Governance functions: <ul style="list-style-type: none"> • Monitoring: medium • Resource: medium • Strategy: high
	Low “Velocity”	<i>Quadrant 4</i> <i>“Re-invention” threshold</i> Governance functions: <ul style="list-style-type: none"> • Monitoring: low • Resource: medium • Strategy: medium 	<i>Quadrant 3</i> <i>Maturity/decline threshold</i> Governance functions: <ul style="list-style-type: none"> • Monitoring: high • Resource: low • Strategy: low

Figure 2. Strategic ‘thresholds’ and the roles of corporate governance
Source: (Filatotchev *et al.* 2006: 261)

Filatotchew *et al.* (2006: 262) argue that when it comes to the different functions inherent in corporate governance there are three predominant functions encompassing the governance of the firm, which are broken down to monitoring, resource and strategy. Four combinations of these three functions, are related to one of the four quadrants that are the examples of the four thresholds through the stages of the company. Monitoring equals ensuring accountability and giving credibility of shareholder’s wealth. Resources include the supply of input, like financial capital, knowledge, legitimacy, etc. Strategy is

considered as the counselling and advising role of board members and employees and is important as input to management for taking proper decisions.

Giving more depth to the Figure 2 the *Quadrant 1* illustrates newly started companies, which are highly dependent on external resources. Although, Filatotchev *et al.* (2006: 261) are referring in *Quadrant 1* to Founder/IPO threshold, in the author's opinion this may be interpreted that this threshold includes also the first and following rounds of capital raising. Typically, the resources include capital need for day-to-day operations, capital expenditures, research and development costs, payroll, etc. Accompanying element of young companies is heavy focus on the growth, meaning there is strong strategic direction to expand and enlarge. Monitoring need at this stage is relatively low as the founder often acts actively in the management role also.

Companies in *Quadrant 2* have grown larger and found it appropriate to seek external funding from institutional investors or from the stock exchange and subsequently also exposed to external investors interested in seeing their funds being well spent. This obviously requires higher monitoring need to give more transparency and reliability especially for the financial reporting. Companies in *Quadrant 2* are becoming mature and build up sustainable cash flows, enough liquid funds, which result to less resource need as compared to *Quadrant 1*. Evolving through the corporate life cycles the strategy element is still in focus.

In *Quadrant 3* the companies have matured and some are even in a decline phase. Monitoring requirements are increasing and more emphasis is put on the analysis for protecting the wealth of the shareholders. Both resource and strategy need decrease as the company struggles to innovate and continues along the same path as before. At the turnaround and "re-invention" phase in *Quadrant 4* less emphasis is put on the monitoring need and more to strategy. Resources are seen as inevitable for the "re-invention". The difference to the *Quadrant 1*, is the speed with which the strategic environment is changing.

Filatotchev *et al.* (2006: 258) have extended agency research by suggesting that in addition to monitoring and control, there are resource and strategy functions. In the following, the author explains the change in the expectations to internal corporate

governance mechanisms by synthesising the theories mentioned above and illustrates it with the results of research papers from various scholars. Despite the fact that the literature covers mostly large and often listed companies and in many cases one-tier board models, the examples and findings from the studies related to the start phase have been presented in the next paragraphs.

Monitoring. Harjoto and Hoje (2009: 61) used a life-cycle approach to examine how board leadership, value and company's performance are affected by corporate governance and monitoring mechanisms. Their study investigated the link between CEO's direct influence through power and the company's performance. Although, it is largely accepted that CEO duality does not improve long-term business success, Harjoto and Hoje (2009: 38) concluded that CEO concentration, a proxy of CEO duality, is positively affecting firm value and operating performance for early stage firms. However, they still confirm the uniformly accepted norm that CEO duality negatively affects firm value for more mature firms. Therefore, the perspective of expectations to board composition attribute is changing and CEO duality suits more to early stage companies and less to mature firms. Huse and Zattoni (2008: 91) conclude that the trust relationship between the board members, internal and external agents contribute to the changing role of the board in the different corporate life cycle phases.

Beuselinck and Manigart (2007: 271) have examined the influence of ownership concentration mechanism on financial reporting quality in private equity backed companies. Their findings supported agency theory predictions that private equity investors with low equity stakes have a high need for high quality accounting information whereas private equity investors with high equity stakes have other means to closely monitor their portfolio companies. This proves that the expectations to mechanisms are changing and also aligning with the governance functions through the lens of corporate life cycle approach where institutional investors with minority share are expecting high level of monitoring to avoid information asymmetry conflicts.

To follow with the board activity attribute, board attendance and number of board meetings is deemed an important variable. Huse and Zattoni's (2008: 88) findings suggest that in the decline stage of the corporate life cycle of the company (Huse and Zattoni define this stage as "crisis") requires higher board intensity as monitoring is a function of

the intensity of the interaction between board and management. On the contrary, Huse and Zattoni (2008: 88) state that in the start phase the main task of the board is related to legitimacy and in the growth stage to advisory tasks, respectively.

Resources. Filatotchev *et al.* (2006: 258) define resources as the company's resource base and "resource dependency induced structures of accountability". Governance choices have an impact on the value creation in the company that comes from the access to rare, costly and inimitable resources (Coff 1999: 128).

Lynall *et al.* (2003: 427) have concluded that powerful CEOs and external financiers together with the organisational life cycle drive the board composition at the company's founding. As an example of resource dependency perspective, they point to young companies need to prove legitimacy to external investors when these young firms seek funding. Independent board member offers a wider network, reputation and council assistance resulting more legitimacy to the management in their quest for funding. The authors emphasise the importance of path dependency to understand the dynamics of company boards. They conclude that organisational life cycle theory is a useful framework to allow for the analysis of path dependency, meaning the natural progression for firms is from introduction, growth to maturity.

Clarysse *et al.* (2007: 244) have examined the determinants of board composition in high technology start-ups drawing on agency theory, resource dependence theory and social network theory. Specifically, they examine the tensions that exist between the founding team and shareholders in determining the board composition. Their results provide evidence that teams, which have powerful shareholders (e.g. venture capital firms) are more likely to develop boards that have complementary skills in contrast to those of the founding team. Conversely, in start-ups where the founding team has had autonomy in composing their board, the team tends to look for outside board members with similar human capital.

Especially for early stage company's remuneration system with variable pay is always important topic in the light of resource availability and acts as a management remuneration mechanism. Variable pay in the form of bonuses, share or option schemes, has gained more importance (Filatotchev, Allcock 2010: 20). This development has often

been motivated by agency theory in the sense that the agent would prefer fixed salary and the principal would prefer variable pay in the form of performance related bonuses, options or share programs. The ultimate goal of such incentives is to align the management interest with owners. Filatotchev and Allcock (2010: 21) argue that older companies in the mature phases of their corporate life cycle may have more diversified resource pool and experienced management team. As a result, they refer that there might be greater need for formal incentive alignment mechanisms compared to younger, founder-owned firms in their start-up phase, which may have narrower resource bases and thus higher focus on reputational aspects of governance. Therefore, depending on the stage of the company's life cycle, there are reasons to set up their incentive systems differently as the organisational needs are different. Moreover, early stage companies are very often with a narrower resource base and are temporarily dependent on external resources as it seeks to expand its resource base.

For new companies, entrepreneurial firm has a narrow resource base. Usually founders have a significant ownership stake. In this situation Filatotchev and Allcock (2010: 24), argue that equity-incentives to management may be ineffective in cases where only the founder's wealth is tied to that company due to the low level of managerial accountability to external shareholders. As the firm receives risk capital backing, the company turns from entrepreneurial firm to "professional" firm and management with equity pay start to be held accountable to all shareholders, leading to a situation in which equity-incentives can be better matched with the resource needs of the firm without putting the firm at risk for unwanted behaviour (Filatotchev, Allcock 2010: 25). When it comes to maturity, shareholders demand management to deliver growth and equity-pay is used as incentives. However, in cases where there are few growth opportunities left, management often sets out on an acquisition path that results expansion and to complex diversified organisations. These large organisations lack the transparency that allows the board to monitor management's actions. This eventually results in a situation in which management sits with significant power, a situation in which it can be detrimental with equity-incentives (Filatotchev, Allcock, 2010: 25).

Strategy. Brunninge *et al.* (2007: 295) investigated how governance mechanisms affect the ability of small- and medium-sized enterprises to introduce strategic change. Building

on agency theory on small firm governance they suggest that governance variables related to the board of directors and the ownership concentration mechanisms all affect strategic change. They point out that it is important to examine the relationship of these governance mechanisms. Specifically, they find that closely held firms such as owner-managed companies, exhibit less strategic change than small- and medium-sized enterprises, which are relying on more widespread ownership structures. They suggest that closely held firms can achieve strategic change more easily by utilising outside directors.

As covered above, the expectations to internal governance mechanisms are changing in the start phase of the life cycle. It is evident that applying one specific corporate governance mechanism does not give the solution to the entire corporate governance problem. Rediker and Seth introduced the concept of the “bundle of governance mechanisms” in 1995 under the section titled “Cost-Benefit Analysis” (Ward *et al.* 2009: 648). Aguilera *et al.* (2012: 379) argued about the bundle as a useful tool to examine corporate governance models across and within countries, emphasising that the bundles of corporate governance practices are becoming more important in comparative corporate governance researches.

The bundle of mechanisms was analysed in Aguilera *et al.* 2008 research paper from the perspective of cost, contingencies and complementarities. In the author’s opinion the cost is associated to any implementation of governance mechanisms. This explains why the recent focus of the studies builds on the substitutability and complementarity (e.g. Aguilera *et al.* 2012, Aguilera *et al.* 2015, Aguilera *et al.* 2016). Aguilera *et al.* (2012: 381) categorised the mechanisms could be analysed in the bundle based on: 1) substitutability: when one mechanism acts as a substitute for another mechanism, and 2) complementarity: when the adoption of one increases the marginal returns of the other. An example of substitutability is related to managerial incentive plans – if managers interests are aligned with shareholder interests such that acting in the best interest of shareholders is also in the best interests of the managers, then the need for the board to monitor the actions of management on behalf of shareholders is reduced and the governance mechanisms are substitutable.

Zajac and Westphal (1994: 135) concluded that the use of long-term incentive plans for CEOs are negatively related to the monitoring processes in place, whereby lower

incentives to CEOs are generally more likely to have governance structures that provide higher level of monitoring of managerial behaviour and companies that have stronger incentive alignment tended to have weaker monitoring. However, Ward *et al.* (2009: 648) propose that in some circumstances, instead of acting as substitutes, monitoring through board of directors and incentive alignment may act as complements to one another, where the presence or addition of one mechanism strengthens the other and leads to more effective governance in addressing agency problems.

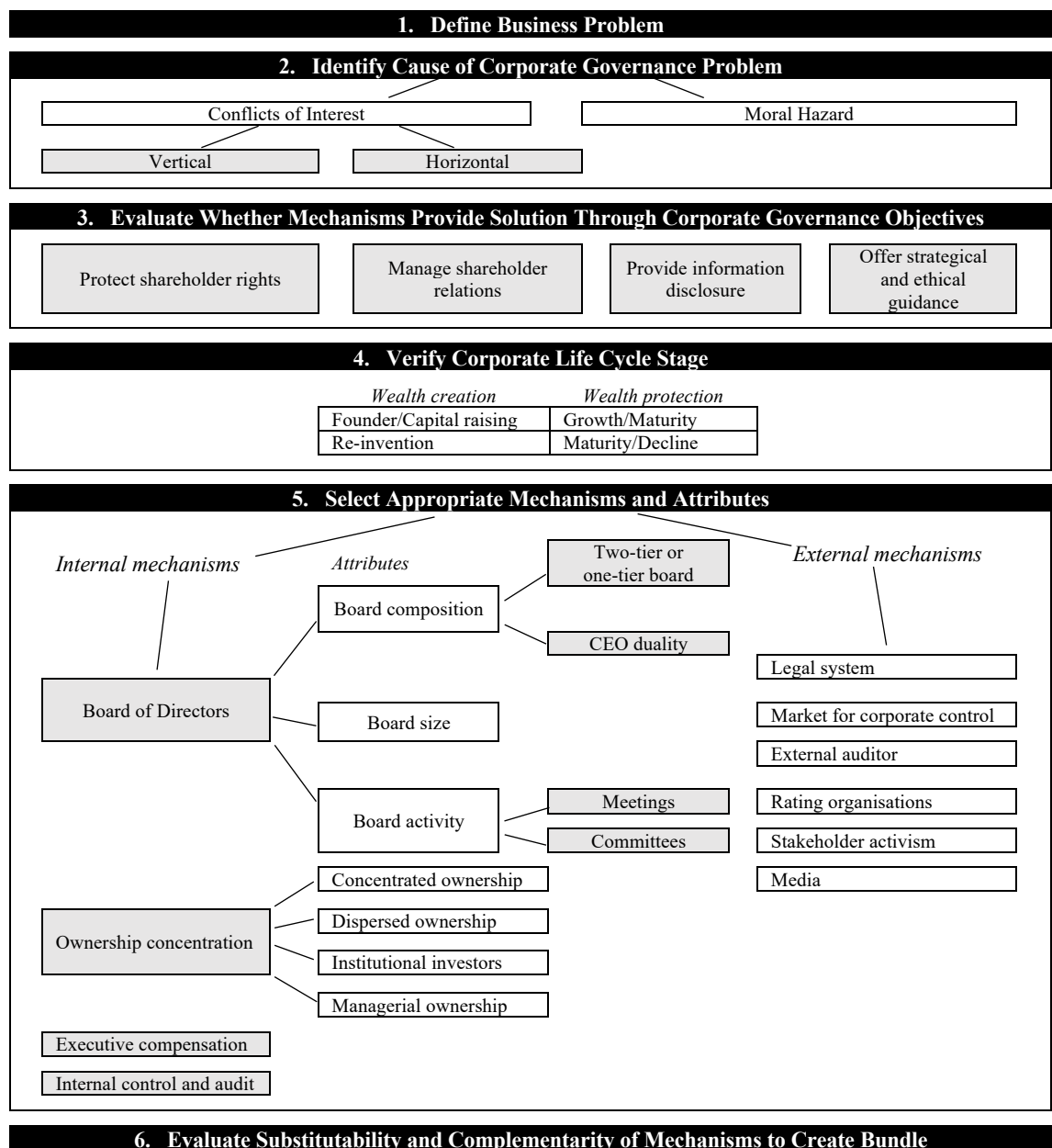


Figure 3. Model for addressing the governance problem the company in its start phase (compiled by the author).

To summarise the section, it has been proved that the expectations to the internal governance mechanisms in the start phase of the company are changing. To capture extensive information covered earlier about the corporate governance problems, objectives and mechanisms, the author has built the model, which can be used for addressing to the governance problems in practical way. To synthesise theories with practical business problems, the author is introducing problem-solving through defining the actual problem cause for corporate governance problem. The summary is presented in the Figure 3.

There is no right answer, which of the mechanisms are providing the best solution to the corporate governance problems or which mechanisms should be included in the bundle. Therefore, different companies apply corporate governance mechanisms in their own way. One set of mechanisms solving the issues might not be appropriate to another company. Furthermore, as concluded the expectations to the set of mechanisms are changing over the time depending on life cycle stage.

In the companies in their start phase the primary focus of the corporate governance objectives narrows down to the shareholder level instead of satisfying wider stakeholder view. Therefore, in the next chapter the model and further analysis of the case company deal with the objectives narrowed down to shareholder view. Some internal corporate governance mechanisms have number of attributes, e.g. board composition and board size are the attributes to the board of directors mechanism. In the next chapter internal mechanisms in the case company are analysed at the attribute level.

2. EMPIRICAL RESEARCH ON CHANGES IN INTERNAL CORPORATE GOVERNANCE MECHANISMS

2.1. Research Method and Introduction of Case Study Organisation

The empirical study of this thesis is based on the company that is providing innovative robotic solutions for challenging environments. To achieve the aim the author has selected case study method, which is part of qualitative research. The data source for the case study is based on the document analysis and on the semi-structured interviews with the shareholders, supervisory board members and CEO. The questionnaire has been included in the thesis as Appendix 1. The author has used explanation building technique for data analysis.

The selection of research strategy is based on the following arguments:

1. Qualitative research is characterised by an interpretative paradigm, which emphasises subjective experiences and the meanings they have for an individual; therefore, the subjective views of a researcher on a particular situation play a vital part in the study results (Starman 2013: 30). As the change to expectations towards internal governance mechanisms have not been researched in Estonia, the author concluded that building the summary and conclusion based on documents and experiences of individuals in the company, the qualitative research method was most appropriate.
2. Case study method was selected as empirical inquiry investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident (Yin 2012: 4). In other words, case study method is applicable when it is impossible to distinguish studied phenomenon from the environment it is happening in. Case study method is appropriate when addressing questions “how” and “why” (Yin 2009: 27).

3. To address to the research question of how the expectations are changing, the explanatory case study type was selected as this is used to seek to answer a question that sought to explain the presumed causal links in real-life interventions (Baxter, Jack 2010: 547). As the thesis is aiming to answer the question *how something happens*, it refers to the explanatory case study type. Developing the understanding from the perspectives of the shareholders in the case company enables explaining the changes in the expectations towards internal governance mechanisms in the start phase of the company.
4. Single-case study design with single holistic case was chosen (Yin 2012: 7) to address the research question. Further studies with different methods might be necessary to enlarge the target groups to analyse multiple entities so that the conclusions can be elaborated to other similar companies, which is out of the scope of the master's thesis.
5. An integral piece of carrying out a case study is data collection. Driven from the nature of the master's thesis of being explanatory type, interviews were used for collecting data (Saunders *et al.* 2009: 140). The semi-structured interview type was chosen as the researcher will have a list of themes and questions to be covered, although given the context some questions may be omitted from particular interviews depending on a particular interview (Saunders *et al.* 2009: 320). To add objectivity to the information obtained from the interviews and identify the gaps in the information provided, review and analysis for relevant existing and available documents were performed. There were two applicable documents relevant in the context of the study: articles of association of the case company and shareholders' agreement. There were no internal policies or procedures regarding the roles of the management board and/or the supervisory board in the case company. Therefore, the document analysis focused on the two abovementioned documents.

Design of research approach to the questions in empirical section imposes limits on the scope of using master's thesis as follows:

1. The observations made and conclusions reached in the thesis might not be generalisable to other companies in the start phase of their life cycle.

2. The study presents the opinions and statements from the interviewees at the single point of time, i.e. cross-sectional study, but does not present their changes over the time, i.e. longitudinal study.

While selecting the interviewees, the target population was defined as all shareholders, all supervisory board members and the CEO of a case company. All participants were available to the author for interviews. Defining the sample size the author was relying on the recommendations in the literature where 1) budget constraints (including time) should be considered, which prevent from serving the entire population; 2) the number of continuing interviews should be considered to collect qualitative data, such as by conducting additional interviews, until data saturation is reached: in other words until the additional data collected provides few, if any, new insights (Saunders *et al.* 2009: 234-235). Based on the non-probability technique, purposive sample type was selected, which enables to use the author's judgement to select cases that will best enable to answer research question and to meet objectives. This form of sample is used when working with very small samples as in the current case study research and when the purpose is to interviewees who are particularly informative. (*Ibid.*: 234, 237).

At the time of conducting the interviews, the number of shareholders, supervisory board members and CEO included in the sample size totalled to ten. Due to the overlapping positions among the persons in these three groups (CEO being also the shareholder and some supervisory board members are also shareholders) the final sample size was six. As four interviewees were asking to leave their thoughts, recommendations and experiences anonymous, the author has not specified, which data is collected from particular interview. In the current master's thesis the reference numbers regarding respondents after quotes are rearranged and not directly linkable to persons in Table 3. The author believes that anonymous sources of data inputs does not harm the value and validity of the research results. The length of the interviews depended on several factors and lasted for 45-90 minutes. All interviewees were presented with the version of the master's thesis submitted for pre-defence on 22 April 2020. Interviewees were asked to review the statements, summary, interpretations and conclusions from the previous interviews during the period of 13-19 May 2020 and to correct any possible errors in misunderstanding their responses about the definitions used and any other matters related

to their interview response. Follow-up interviews were conducted covering the same questions as in earlier interviews. Definitions and purposes of the interview were explained in detail based on the presented version of the master’s thesis. Feedback from the interviews were taken into account when finalising conclusions in the study to assure common understanding of the definitions used and concluded results. The sample for selected interviewees is presented in Table 3.

Table 3. Sample for Empirical Study Data Collection From Interviews

Name	Position	Time of Interview	Time of Follow-up Interview
Kuldar Väärsti	CEO / Majority shareholder	22 October 2019	19 May 2020
Toomas Bergmann	Supervisory Board member, shareholder	10 February 2020	19 May 2020
Urmas Past	Shareholder	21 November 2019	19 May 2020
Rünno Pajumägi	Shareholder	16 December 2019	19 May 2020
Lauri Paeveer	Shareholder	13 March 2020	18 May 2020
Jana Koppel	Supervisory Board member	21 November 2019	18 May 2020

Source: Compiled by the author

Analysis of articles of association and shareholders’ agreement of the case company was conducted to validate and corroborate the information obtained from the interviews. Articles of association has relatively standard wording and covers also drag-along and tag-along rights, which protect shareholders in case of the change in corporate control. There are elements of supervisory board members appointment rights, which play the role in the supervisory board composition. Shareholders’ agreement is subject to strict confidentiality clauses and the details are not available for disclosure. Therefore, the scope of limitation is established regarding the availability of the information despite the fact that some elements are covered in the shareholders’ agreement.

In summary it can be concluded that the interviewees in the sample represent sufficient views in analysing research aim together with the document analysis of identifying how the expectations to internal corporate governance mechanisms are changing in the case company.

Introduction of the organisation. The case company is Milrem AS that is providing innovative robotic solutions for challenging environments. Milrem AS was established in

2013 and the current business unit with its strategy, products, clients and customers was created during the demerger, when the company's core business was divided into new company Milrem LCM OÜ. As the case company Milrem AS (hereinafter Milrem) was prior to demerger creating new innovative robotic products and solutions, it can be concluded that this was classical spinout as referred by many authors (Uhlener *et al.* 2007: 232, Filatotchev *et al.* 2006: 265).

Milrem's main activity is largely divided into three categories: production and development of unmanned ground vehicle for defence and commercial use, development of large unmanned ground vehicle for defence sector and research and development of artificial intelligence for own produced unmanned ground vehicles. With its first product and subsequent improvements the main focus has previously been on the development and production of unmanned ground vehicle for the defence and commercial purposes with the existing vehicle THeMIS, which has already been sold to the Netherlands, Norway, Germany, Indonesia, the UK and the United States. Over the recent years substantial amount of resources (human and capital) has been allocated to the development of TypeX – next generation large battlefield vehicle, with hybrid powertrain (electricity and diesel) and fully autonomous capacity with its main task of supporting main battle tanks and mechanised units. The third area of activity includes various research and development areas considering autonomy functions for the unmanned ground vehicles like navigation etc. Numerous engineers and scientists are working with diverse topics to find most suitable and efficient solutions to support the artificial intelligence of unmanned ground vehicles. As of 31 December 2019, Milrem employs 119 people and has offices in Tallinn, Tartu and Örnsköldsvik (Sweden). According to the financial statements for 2019, total revenues of the company accounted for 5 million euros.

Typical for the new spinout companies, which are focusing heavily on the development of new technologies, the expenses increase more rapidly than the revenues, which result into deficiency in liquid funds. Milrem has raised funds from four sources: mezzanine loan from institutional financier, new investors via direct investments during capital raising, convertible loan instruments as well as bank loans. While the company has had only the founding shareholder and raised capital since spring 2019 the author classifies

Milrem life cycle stage into *Quadrant 1* as per model referred in Table 3. The categorisation is the same according to Filatotchev *et al.* 2006 framework presented in Figure 2 while the adjustment to their framework by author was explained and argued in the previous chapter. According to theory described, companies at this stage will essentially need resources, include capital need for day-to-day operations, capital expenditures, research and development costs, payroll, etc.

Evolving in corporate life cycle and introduction of new shareholders in Milrem, the company has faced several business-related problems. From the interviews the author summarised four mostly mentioned strategical problems. In summary the problems, which were evaluated for the case in the current research are:

- **Strategical focus in limited resource environment.** Milrem has focused heavily on many directions of research and product development being sure that the market exists for its developed products. As a result, with the will of necessary aggressive expansion, the company has lost some of its focus for directly value creating activities. Outputs from the research teams have not been always connected to the products the company is able to develop and produce.
- **Concluding sales agreements.** Driven from the company's strategy, the focus has been built on developing advanced technology and not that much on using all the efforts for allocating enough resources to finalising sales agreements. The market dynamics in defence area involves often political decisions with public procurement process, which takes long time the company does not have. Lack of finalised sales deals puts additional liquidity stress to the entire organisation.
- **Information asymmetry between shareholders, supervisory board and managers.** Additional liquidity stress, which is not unusual for start-ups or spinout companies has not always been communicated openly among all shareholders, supervisory board and managers. To keep the motivation high, building good employer reputation and competing on the labour market to provide all "bells and whistles", Milrem has created an image with very successful start-up company.
- **Access to capital.** Shortage in sales and non-acceptance to communicate the need for cost reduction has put Milrem to the situation where capital raising is unavoidable. Driven from different factors from strategy focus, low level of sales

and information asymmetry, the access to capital has from time to time been difficult.

For addressing the governance problem, the author has compiled the model based on theory covered in the first chapter as presented in the Figure 3. Finding the mechanisms and attributes to reduce governance problems starts from the definition of business problem. Without in-depth analysis of the issue, author believes that the approach to establish governance mechanisms may turn to overregulating governance function, which may build unnecessary procedures and bureaucracy that could be avoided. The next phase after defining the business problem is identifying the cause of the governance problem. As concluded in the previous chapter, the corporate governance problems could occur either as conflicts of interest and/or moral hazard problem. The one does not exclude the other, meaning both of the problems could occur simultaneously. Depending on the horizontal (principal vs principal) or vertical (principal vs agent) conflicts of interest issue, the application of the mechanisms could be different. Prior to selecting mechanisms, it should be evaluated whether the mechanisms could solve the governance problem through meeting governance objectives. This would be informal procedure based more on the professional experience without any strict decision-making framework. Verifying the start phase of the corporate life cycle stage guides the focus on the monitoring or resource dependence questions.

Figure 3 presents mostly used governance mechanisms and attributes to address the governance problems. Based on the theoretical literature covered in previous chapter, the board of directors is one of the most researched mechanism that play key part in addressing the issues. In the context of Estonian legislative system some of the board attributes are not usable in the case company. Based on the Estonian Commercial Code only two-tier board system is allowed in public limited liability company (*aktsiaselts*), which eliminates the availability of CEO duality mechanism. In parallel with internal mechanisms, legal system, market for corporate control, etc. defined as external mechanisms provide solutions to governance problems. Finally, once the mechanisms and attributes have been selected, their substitutability and complementarity should be evaluated to avoid opposite effects and to gain efficiencies in terms of cost, reducing unnecessary processes and regulation.

Analysing the business problems summarised from the interviews above the author reached to the conclusion that ‘concluding sales agreements’ and ‘access to capital’ are both path-dependant from the strategy, meaning it is highly unlikely that both, the absence of sales and access to capital, could exist without the strategy issue. The opposite construction could exist, proving that the strategy question is one of top management’s primary concerns as it is crucial for a given firm’s survival and for creating wealth for its shareholders (López-Cabarcos *et al.* 2015: 1). Information asymmetry was brought up, which inherently is not the business question, but rather fundamental element while discussing governance problems. Asymmetry co-exists with the conflicts of interest as covered in the theory chapter under agency problems and being often the cause of moral hazard issues. As the information asymmetry problem brought up in the interviews may play vital role in the strategy problem, the author has selected the strategy business topic for building the case study research based on the model presented in Figure 3.

1. Define Business Problem Milrem has grown along with the focus on developing new technology and being one of the leaders in innovative defence focused companies in the world. Innovation has been one of the core values throughout the organisation culture. Scientists and engineers in the company have been given relatively unrestricted areas of research to study new technologies that might turn to be useful and usable for the company. In addition to the flexibility of setting the roadmap for research areas, the company has applied for government grants, which are covering some of the costs incurred from payroll and outsourced service expenses from engaged university teams. The output of research and development teams have not always been implementable to the product the company can sell within the next couple of years. Driven from the need and momentum for rapid expansion, the focus from the product has shifted to the technology.

The business problem defined above is the different views among shareholders on the strategical focus of the case company. The ‘crisis’ (as defined by Greiner in his growth model) was predictable as the case company has evolved through the phases of growth model first introduced by Greiner in 1972 (Greiner 1998:3). The model describes the growth issues leading to leadership, autonomy and control crises, which are all applicable to the case company. While having passed leadership and autonomy crisis (the content

and theory will not be explained in the master's thesis), the case company has faced control crisis where there are number of divisional managers that cannot be controlled and coordinated by the CEO (Greiner 1998: 7). This caused the situation described above of allocating resources to various areas for development and not controlling the outcome. One of the interviewees brought specifically out the following:

“Milrem is facing typical start-up company problem with product/market fit question. The problem for the spinout companies focusing more on the technology rather than to the product is the rapid consumption of available funds as the technology has to be proven for the potential customers and the need for the developed solutions has to be still created.” (Respondent 1).

This means that at the start the customer base for selling the products and covering the incurred costs is not existing. Several research projects are creating various ideas for further developments. In the situation where the roadmap for such activities is not fully followed there will be usually non-value creating activities, which do not support the core products of the company. With the loose control, the focus gets more distracted and the outputs might have nothing to do with the initial goals. This results to additional resource need in terms of cash and manhours, which are increasing rapidly, making the research and development division even more extreme cost centre. As the long-term research and development work without paying clients and limited cash resources is not sustainable, the primary incentive for the strategy need is lack of liquid funds to support research and development activities. Efficient corporate governance structures should be designed to encourage investors providing early stage investment.

2.2. Analysis of the Changes in Expectations to Internal Governance Mechanisms During Capital Raising

In the current section the analysis of expectations changes towards internal corporate governance mechanisms in the start phase of the case company has been performed according to the steps in the model developed by the author presented in theory chapter Figure 3. As explained in the introduction and in the previous section, the master's thesis is limited to analyse only the internal governance mechanisms. Therefore, the study excludes external mechanisms from its scope. The limit of scope was also established not

looking beyond individual mechanisms, which consequently leaves the bundles for future research areas. In previous section the first step of identifying business problem was explained and defined. The current section covers steps from two to five in the model.

2. Identify cause of corporate governance problem. The second question in the model, that the interview questionnaire addresses, was to find out the causes of the business problems. As covered in the previous section in the context of business issues, an information asymmetry was brought up as an element in the governance problems. All interviewees responded negatively to their perception of horizontal and vertical dimension of conflicts of interest problem. The next, moral hazard problem was questioned, which appears in the context of case company in the situation where the manager is willing to take more risk while not bearing the same financial risks with the investors. One of the interviewees commented business decisions:

“Sometimes the decisions in the company are incomprehensible. Based on the information presented to me, I feel that I would have done different decisions.”
(Respondent 4).

It can be concluded that new investors who have recently invested into the case company prefer concentrating the efforts and resources on the services and products, which will produce quick cash flow and increase the value of their investment. For the purpose of finding out the cause of moral hazard problem, all members in the sample group responded positively to the information asymmetry question and asserted that if the information will be fully and timely shared among the parties, the probability of moral hazard problem occurrence, reduces significantly.

Jia (2015: 688, 70) studied financing start-ups from moral hazard, information asymmetry and the reallocation of control rights, and concluded that among the start phase of the companies with multiple shareholder, the existence of moral hazard problem exists frequently due to the information asymmetry causes. The same conclusions were reached in Pollman research paper (2019: 183, 186). The results of the studies are in line with the conclusions among sample group in the current study. The reason for such problem occurring is that one party is willing to take more risk while it has less to lose compared to other party. In the context of the case company, CEO appears to accept more risks in

terms of allocating the company's resources as described in the previous section. It may be questioned that while CEO is also holding the majority of the shares in the case company, how CEO has less to lose? The answer should be sought from the time horizon of the investments. While raising the capital for the company, the founder is usually not investing and diluting the shareholding while the company issues new shares. At this moment of time, the founder has accepted with the dilution, the same time the shares usually gain value through equity investments made by investors. Looking from the cash basis perspective, the founder has nothing to lose at this stage, while the new investor having evaluated the investment risk, still bears the full risk of losing all the cash investment in the company.

Despite the fact that the document analysis provided solutions to reduce information asymmetry issues, the author has concluded that the source of business problem was moral hazard that occurred through the information asymmetry issue.

3. Evaluate whether mechanisms provide solutions through corporate governance objectives. Identification of corporate governance problem causing the business problem, was not defined and concluded during the time of carrying out the first-round interviews. During the follow-up interviews after all interviewees having familiarised themselves with the initial case study results, all respondents agreed with the first two steps covered in the model. All participants concluded that in case 1) protection of shareholder rights, 2) management of shareholder relations, 3) provision of information disclosure and 4) offering of strategical and ethical guidance objectives are met, then this probably solves the information asymmetry question and reduces the moral hazard problem.

All participants in the sample group have long term experience in conducting business. Based on their professional experience and judgement, it was concluded that meeting governance objectives will most probably solve the governance issue in the case company.

4. Verify corporate life cycle stage. The fourth step in the model is verifying the company is in the start phase of its life cycle and guiding to which governance functions the problem solver should direct focus. To classify on the broader scale the life cycle stage the question, the interviewees were asked to evaluate whether the company is in

‘birth’, ‘growth’, ‘maturity’, ‘revival’ or in ‘decline’ stage as per Miller and Friesen framework covered in theory chapter. Responses were mostly referring to growth and birth stage. The next targeted questions asked to put the life cycle stage in the context of Filatotchev *et al.* 2006 framework, which has been adjusted by the author by rephrasing the first quadrant as ‘founder/capital raising’ according to the model in Figure 3. All respondents concluded that the case company is in the transition phase of ‘founder/capital raising’.

In addition, the aim was to find out how the expectation to monitoring and resource governance functions are changing by asking to evaluate how much importance should be paid to those functions. All members in the sample group highlighted the importance of resources, which is in line with the conclusions of Filatotchev *et al.* 2006 study conclusions covered in theory chapter. Prioritising the monitoring function appeared to be major difference among respondents. The founder left the monitoring function with lower priority, while first-round investors and supervisory board members emphasised on the importance of having better overview about the budgets, results and other financial key performance indicators. This means that especially investor is expecting to pay more attention and reliance on monitoring function comparing to the founder. The same conclusions have been reached also in Jia study (2015: 688, 700) of reallocation of control rights in start-up companies that investors expect stronger monitoring function than founders.

In accordance with the model in Figure 3, separating the monitoring and resource functions proved to be useful, as it mirrored back to the information asymmetry problems in step two (identifying the cause of corporate governance problem). After the life cycle stage has been verified, theoretical research results provide guidance to addressing monitoring and resource functions, which can be used to solve moral hazard problems and information asymmetry issues.

5. Select appropriate mechanisms. Based on the theoretical literature covered in previous chapter, the following internal corporate governance mechanisms and attributes were covered for analysis:

1. Board composition – is attribute of the in board of directors mechanism. Board composition deals with the characteristics of the board members about their background, gender, age groups etc.
2. Board size – is attribute of the board of directors mechanism. Board size describes the number of board members in the board.
3. Board activity – is attribute of the board of directors mechanism. Board activity deals with the role of the board, how the procedures in the board are set, the frequency of board meetings and committees working under the board.
4. Ownership concentration – describes which of the owners can control and influence the management of the firm to protect their interests.
5. Executive compensation – in the literature is often referred also as manager remuneration – regulates how the executives are compensated for their work.
6. Internal control and audit – additional control and monitoring mechanism reporting to board of directors or to shareholders.

From the responses to interview questions, all participants concluded that the size of the board is not important until it stays within the normal size practice compared to other companies. The need for internal control and audit for the size of the case company, was considered unnecessary at this stage; the same was for board committees, respectively. Only the founder had the opinion about the frequency of meetings for supervisory board members, while other respondents did not have an opinion on this matter. The answers regarding the size of the supervisory board, meeting frequency and committees of the supervisory board, and internal audit function did not provide sufficient information for further analysis in the context of the master's thesis that analyses the how the expectations towards governance mechanisms are changing. Therefore, these elements are excluded from the further analysis, which from now onwards focuses on the board composition and role attributes of the board of directors mechanism, ownership concentration and executive compensation mechanisms.

The answers summarised in Tables 4-7 are structured as the expectations prior and after the capital raising. The second dimension separates the answers between founder and first-round investors. There were no expectations from the first-round investors prior capital raising, therefore, this table cell does not contain any information and is filled with

grey colour. The reason not presenting the answers from the supervisory board members separately is that the majority of the supervisory board members is appointed by the founder and therefore represents mostly the opinions of the founder. Minority of the supervisory board members is appointed by first-round investors representing mostly the opinions of investors. Therefore, the answers from supervisory board members have been allocated either to the dimension of founder or first-round investors. The outcome and conclusions of the study have been compared and explained with the opinions and conclusions in research papers.

According to Filatotchev *et al.* 2006 framework as explained in the first chapter, the expectations to the board composition should change as the companies in this stage have an increased need for additional resources, of considered knowledge, legitimacy, financial resources, etc. The consolidated answers from the current study have been summarised in Table 4 below.

Table 4. Expectations to Supervisory Board Composition

	Prior capital raising	After capital raising
Founder	<ul style="list-style-type: none"> • Build reputation of the company • Provide help in strategical discussions • Build network among regulators • Support discussion of founder ideas 	<ul style="list-style-type: none"> • Increase legitimacy to the decisions • Build reputation of the company • Bring knowledge resources • Bring business connections • Support founder ideas • Have sufficient time to meet the role expectations • Have no shareholding nor incentive programs in the case company
First-Round Investors		<ul style="list-style-type: none"> • Act for the good of the company • Support with experts in the fields necessary for the company's growth • Represent also the interests of minority shareholders • Include high number of independent board members • Have no political background

Source: Compiled by the author

The composition of board members has changed twice during 2019. The reason for the changes has been clearly initiated from the need to involve more human and social capital in the company. This is to build larger network of useful connections, reputation and facilitate advisory and counselling role for the company's management team. According to one interviewee:

“The members of the supervisory board should bring new competences into the company. The need of those competences to the company should be evaluated annually and the members in the supervisory board should be replaced if the needs of the company are changing.” (Respondent 3).

Persons with extensive experience in managing smaller and larger, growth and mature, domestic and international companies have been appointed to the supervisory board. First-round investors mentioned that there has been relatively limited experience among the supervisory board members in the field of research and development, robotics, artificial intelligence and production, which to their opinion are essential to the company.

In the table above, it can be seen that the expectation to the supervisory board member have changed over the time. Founder's one of the primary expectations was to have access to the resources not available to the company, while preferring persons known to him. Resource needs were defined as facilitating business connections, contributing with the knowledge the company is not willing or able to employ on a full-time basis. This corresponds to the Clarysse *et al.* (2007: 244) findings that in start-ups where the founding team has had autonomy in composing their board, founder tends to look for board members with similar human capital. In contrast, first-round investors preferred more independent experts in the board. Clarysse *et al.* (*Ibid.*: 244) explain that equity investors expect the teams should develop boards that have skills and experience to address the corporate governance problems.

When analysing the board direct influence on the company's strategy, Golden and Zajac (2001: 1105) brought up in their research conclusion on resource dependence theory that independent board members have links that can be used to obtain the financial resources needed for growth, as well as important strategic expertise. Opening up its governance system to external investors, it is likely that investors will prioritise protecting their

investments and expect high competences for understanding the business and risks. This view is also supported by Uhlaner *et al.* (2007: 233) where new equity brings the shift to more transparency and development of board with complementarity skills (Clarysse *et al.* (2007: 244). Therefore, it is logical to expect that first-round investors have required nominating the supervisory board member in accordance their preferences. This is also regulated in the articles of association and shareholders' agreement of the case company.

Board prestige, which is considered the human and social capital of the directors in the board, is especially important for the companies raising capital from private equity sector. The reason being that these companies need to convey a perception of organisational legitimacy to potential investors (Certo 2003: 442). In addition to the strong rational arguments in favour of attracting external expertise whose resources are made available to the company, it is also in the interest of the company to send a signal to the market that they manage to convince directors with a legitimising property to the board. In conclusion, views from sample group demonstrated that the expectations to corporate governance mechanism are changing in the start phase of the company's life cycle. Major differences appeared in views of which characteristics the appointed person should have as covered above.

The essential internal corporate governance attribute of the boards of directors mechanism in addition to above is the board activity. Literature refers to CEO remuneration, CEO dismissal, dividends policy, investment decisions, etc. In the current study it was all aggregated to the 'role of board'. Table 5 summarises the answers from the sample group.

Scholars have concluded that boards in private companies are typically expected to perform less formal advisory tasks and other tasks, such as service tasks including building organisational reputation, advising on business strategy and networking for the company and that this role may change as firms develop over their life cycle (Filatotchev *et al.* 2006: 263). The same can be concluded from the answers received from respondents. Summarising the answers, main changes to the expectation regarding the role of the supervisory board were legitimacy, advisory/counselling role and the increased need for monitoring. Huse and Zattoni (2008: 87) have investigated the behaviour of boards at different stages of the company. Their study concluded that board behaviour

varies from being legitimising during the start-up and to take an advisory role in the growth phase. The same conclusion was made by Lynall *et al.* (2003: 418), where they concluded that for growth companies, it is likely that the presence of independent board members provides management with the legitimacy it needs to convince investors to provide funds. These views correspond to the findings also from the current study.

Table 5. Expectations to Supervisory Board Activity

	Prior capital raising	After capital raising
Founder	<ul style="list-style-type: none"> • Meet minimum formal legal requirements • Provide aid in legal questions • Open the doors to business community • Passive advisory role 	<ul style="list-style-type: none"> • Add value to top decisions by increased legitimacy • Safeguard shareholders' interest • Provide advisory and counselling role to executives • Help in building company structure • Provide independent supportive help to CEO • Build business connections • Support founder ideas • Contribute significant time for the company
First-Round Investors		<ul style="list-style-type: none"> • Build the growth strategy of the company • Improve shareholder relations • Protect minority shareholder rights • Build business connections • Deliver all major and relevant information to all of the shareholders • Manage the proposed ideas and direct the focus to activities, which bring sales to the company • Assess business risks • Take more monitoring role in the company • Provide advisory and counselling for executives • Nominate key executives

Source: Compiled by the author

The next, an increase in advisory role was evident as this was brought up by all respondents. This is due to the need for the strategic function, which is higher in the company's growth phase as this is the point in the company's development, when the

strategy is being set. Filatotchev *et al.* (2006: 262) find corporate boards that provide firms with advice and counsel can prove to be valuable in management's decision-making process in the strategic function, which explains the higher demand for resources per their model presented in Figure 3. One of the interviewees stated:

“The most important task of the supervisory board is to set the strategic goals for the company.” (Respondent 5).

In the case company, the changes in the supervisory board composition have proved that the expectations to board role have changed to complement management's expertise with their network, other resources and legitimising role.

Concern was placed on the quality of the financial data and the expectation for improved reporting system. Introduction of measuring essential financial data through key performance indicators has proven to be one of the efficient measures in achieving goals as recommended by first-round investors. The emphasis on monitoring function importance appears to be different between the founder and first-round investors. The causes of such results were discussed in theory chapter. For instance, Filatotchev *et al.* (2006: 262) conclude that at early stage of the company's life cycle, especially where the ownership and management overlap extensively, the company may not need a monitoring system. This is also concluded by Coff *et al.* (2001: 647) where the authors showed that in young and rapidly expanding organisations, the agency problem and control-related benefits of independent boards are not as prevalent as compared to mature or declining firms.

The case company has had changes in ownership structure by issuing new shares to first-round investors. Interviews explained that the issue of new shares to first-round investors was initiated from the need to acquire additional capital for its operations as the debt financing was not available for the company. The change in the ownership structure has not resulted to governance mechanism change in relation to ownership concentration. The majority of the shares belong to the founder, so there has been no shift from concentrated managerial ownership during the issue of new shares.

Answers in Table 6 summarise that there has not been any change in the expectations regarding ownership concentration mechanism. While injecting new capital into the company, first-round investors have an understanding of the shareholder structure prior and after capital raising. Therefore, the expectations towards ownership concentrations mechanism agree with the founder’s opinion. The views departed about the managerial ownership. One of the interviewees for example stated the following:

“Ownership concentration is affecting positively the companies in the start-up phase. However, based on my experience managerial ownership results often to variety strategical directions. It is easy to lose the strategical focus as the founder acting also as the CEO is willing to work with several strategies and not willing to abandon undertaken steps. Therefore, in my opinion it is essential to move to the separation of the shareholder and management.” (Respondent 5).

Table 6. Expectations to Ownership Concentration

	Prior capital raising	After capital raising
Founder	<ul style="list-style-type: none"> • Dilute current shareholding as minimum as possible • Best results can be achieved by concentrated managerial ownership 	<ul style="list-style-type: none"> • Dilute current shareholding as minimum as possible • Best results can be achieved by concentrated managerial ownership • Avoid small micro shareholders and keep the total number of shareholders small as much as possible
First-Round Investors		<ul style="list-style-type: none"> • Concentrated ownership brings the best results. • Institutional investor brings more professionalism into the company • Avoid dispersed ownership

Source: Compiled by the author

Although, the views about managerial ownership departed, Harjoto and Hoje (2009: 38), have concluded that CEO concentration is positively affecting firm value and operating performance for early stage firms. This view was shared also by some other respondents who are ready to trade off the managerial concentration with weaker monitoring that was covered above. Concentrated managerial ownership means usually that CEO is more aware of internal information and company prospects than the shareholders. The

downside of this situation is that information asymmetry conditions may appear as managers tend to be opportunistic and may provide different information to the shareholder (Khafid, Arief 2017: 242). Therefore, it is evident that some first-round investors preferred the separation of shareholder and management to reduce information asymmetry. From the interviews, it was brought out that dispersed ownership is avoided as shareholding control tends to be weak because of poor shareholder monitoring.

Research on ownership structure and executive compensation overlaps in the literature on equity-based incentives (Core *et al.* 2003: 27). In the case company incentive plan has not been implemented yet as the company has relied on other motivational attributes to keep its managers interests aligned with the strategy.

Table 7. Expectations to Executive Compensation

	Prior capital raising	After capital raising
Founder	<ul style="list-style-type: none"> • Executives have base salary and no variable pay • Higher base salary and good modern working environment is enough for keeping existing and attracting new employees 	<ul style="list-style-type: none"> • Executives have base salary and no variable pay • Higher base salary and good modern working environment is enough for keeping existing and attracting new employees • Annual bonus will be introduced to all employees in the form of share options with limited vesting conditions not dependant on case company results • Share options increase engagement
First-Round Investors		<ul style="list-style-type: none"> • Due to concentrated managerial concentration no options for the CEO. Reasonable pay level according to the company's results. • Motivating share options for key executives to align their interest with investors

Source: Compiled by the author

Table 7 above presents the views on executive compensation. Two aspects can be concluded: 1) there is change in the view of equity-based incentives from the moment of capital raising, and 2) the views from the founder and first-round investors of how the

equity-incentive mechanism is adopted, are different. One of the respondents had the following opinion:

“Granting share options to all of the employees does not fulfil the motivation and goals achievement targets. If every single employee is in the share options program, then there is no guarantee that there are clearly identifiable persons who are responsible for achieving the targets set commonly in the share options program. I prefer options to key employees.” (Respondent 6).

Walsh and Seward (1990: 428) suggest incentive plans as one mechanism to align managers interests and while properly established, the strategical focus of the company will spread across the entire organisation. The founder could see alternative ways for aligning the executive team’s interest. The contradicting views have been explained by Jensen and Meckling (1976: 326), where strategical changes could be enforced and supported by proper incentive mechanisms preferred by equity investors, while privately held firms generally make it unnecessary for the owners to share the benefits with the managers.

In summary it can be concluded that empirical research shows the expectation to internal corporate governance mechanisms are changing in the start phase of the company in material aspects along with the conclusions by scholars in their studies. Difficulties rise often between the management team and new equity investors because of differences in knowledge, goals and assumptions (Filatotchev *et al.* 2006: 274). In the case company this appeared as moral hazard problem through information asymmetry. Equity investors put more reliance on financial data and controls while privately held firms (status prior capital raising) rely more on informal social controls (Jensen and Meckling 1976: 306).

Scholars have investigated owners’ decisions within the firm and owner influence on innovation. Baysinger *et al.* (1991: 209) found positive relationship between ownership concentration and corporate research and development spending. The same pattern was brought up in the case company research, where the cause of the business issue appeared through moral hazard problem. Corporate governance provides various mechanisms to encourage strategic changes in the company. Brunninge *et al.* (2007: 306) conclude the ownership structure and composition of board affecting most to the strategic change. Two

statements from the interviews summarise well the changes in the governance of the case company:

“I thank the CEO that he has managed to increase the share value of the company. Good corporate governance is essential for successful capital raising. However, corporate governance changes over time and this is challenging for the company and for the management.” (Respondent 2).

“Legal documents in the company need to be properly prepared, so that they do not represent only the minority shareholders nor majority shareholders, but protect the good of the company.” (Respondent 5).

The master’s thesis was by explanatory case study type. Further research questions could include the evaluation of efficiency of selected governance mechanisms by the company, their change over the time by longitudinal analysis. Further research could also cover the evaluation of the impact of external governance mechanisms, which can then be combined with the internal mechanisms and analysed from the substitutability and complementarity perspective.

SUMMARY

Corporate governance is the set of mechanisms, processes and relations by which corporations are controlled and directed. Good corporate governance aims at reducing conflicts of interest and moral hazard risks. The majority of research in this field has been undertaken in developed markets based on archetype of public corporation with dispersed shareholder structure, while smaller private companies have been less the subjects of the research.

According to the author's knowledge, there seems to be no academic research conducted on corporate governance mechanisms changes in the start phase of Estonian firms. The current study filled that gap by exploring the change of the internal governance mechanisms. The master's thesis identified changes in expectations to internal corporate governance mechanisms in the company, which is in the start phase of its corporate life cycle and raises capital. The aim was achieved by covering the corporate governance related literature from research papers and previous studies.

Corporate governance includes several important aspects. As the research area has been approached and analysed from various dimensions, the master's thesis summarised the definition of the corporate governance and explained 'conflicts of interest' and 'moral hazard' problems within the corporate governance framework. Agency, resource dependence and stewardship theories of organisational behaviour were relevant for explaining corporate governance and its functions.

Objectives of corporate governance were defined and explained from the point of finding the solution to governance problems. The difference between internal and external mechanisms were explained. The changes in expectations to internal governance mechanisms were analysed in the context of start phase of corporate life cycle. Based on the theory it was concluded that monitoring and resource governance functions are changing in the start phase of the corporate life cycle.

The empirical research was based on Milrem AS entity. Case study method was selected, which is part of qualitative research. Document analysis and semi-structured interviews with the respondents in sample group were conducted to obtain data for analysing the change in expectations to internal governance mechanisms prior and after the capital raising. Case study followed the steps in the model that was compiled by the author for summarising corporate governance framework.

The main results from the empirical research explained the need for defining the corporate governance problem first. In the case company the cause for the conflicting views in strategy setting was information asymmetry issue that caused moral hazard problem. In this context of the master's thesis the problem occurs in case of certain type of information asymmetry where the risk-taking party knows more about its intentions than the party paying the risk consequences and has a tendency or incentive to take too much risk comparing the party with less information.

From the perspective of case company, board composition and board activity, which are the attributes of the board of directors mechanism and executive compensation mechanism were concluded to explain of how the expectations to internal corporate governance mechanisms are changing. Ownership concentration mechanism did not demonstrate the change. Departing views were related to the managerial ownership, which in the start phase companies is often the trade between having inspiring leader in the management versus weaker monitoring and higher risk for information asymmetry. Analysing the changes in the expectations related to the composition of the supervisory board, there were differences in the views on what characteristics the appointed person should have.

The emphasis on the importance of monitoring function appears to be the main difference in the expectations between the founder and first-round investors. The cause of such results is the perception of additional monitoring need required by first-round investors. Agency theory explains that the investor who is injecting the capital into the company plays the role of principal whereby the company is agent. New equity investor is willing to increase the monitoring routines, while the founder relies more on informal social controls. The scope of persons to be included in the equity-incentive program was the main difference prior and after capital raising. First-round investors preferred equity-

incentives to key persons to align their interest to maximise the value of the firm, while the founder considered it unnecessary to share the benefits with the managers as the alignment of interest can be solved the other way.

The master's thesis is valuable at least to three target groups. It raises the awareness of corporate governance topic, which would result into higher quality management decisions. Firstly, it built further research areas and framework among scholars and students in governance field, which can be further expanded to studying individual or bundles of internal and external mechanisms. Secondly, the analysis is valuable for founders of the company, who seek to build governance functions to improve the quality of management processes and decisions in the companies. Thirdly, investors will understand better the behaviour and thinking process of the founders, when discussing governance issues during the negotiations of capital injection into the company.

Based on the study, future developments and research gaps could include the evaluation of efficiency of selected governance mechanisms by the company to solve the information asymmetry issue and moral hazard problem. Further research could also cover the evaluation of the impact of external governance mechanisms, which can be then combined with the internal mechanisms and analysed from the substitutability and complementarity perspective. The study was focusing on the transition moment of the first round capital raising to new investors. Longitudinal analysis could be conducted to measure the change and effectiveness of the established mechanisms over the time.

Corporate governance has been studied extensively among large corporations mostly in maturity phase in their life cycle, so further research could include young firms in the beginning of their life cycle stages. Successful founder-run companies, such as Facebook, Netflix and Google, open up new research areas in the corporate governance framework by introducing of founder centrism theory. The concept is narrowing the separation between ownership and control while focusing on managerial ownership concentration governance mechanisms.

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APPENDICES

Appendix 1. Semi-Structured Interview Questions

Business problems

1. Please name the major business problems in the company.
2. Bring out the main cause of those problems.
3. How would you solve these business problems?

Corporate governance problems

1. Do you think that business problems can be caused by conflicts of interest?
 - a. Are the problems caused by a vertical conflict of interest?
 - b. Are the problems caused by a horizontal conflict of interest?
2. Are the problems caused by a moral hazard?
3. Do you perceive the problem of information asymmetry in the company?

Corporate governance objectives

1. If all four corporate governance objectives (protect shareholder rights, manage shareholder relations, provide information disclosure, offer strategical and ethical guidance) are met, could the problem you mentioned be solved in this way?

Corporate life cycle stage

1. In which stage of corporate life cycle Milrem is – Birth, Growth, Maturity, Revival, Decline?
2. In your opinion, is the company in the ‘founder/capital raising’, ‘growth/maturity’, ‘maturity/decline’ or ‘re-invention’ stage?
3. How much emphasis and importance should be placed on monitoring and resources for the company in this phase?

Corporate governance mechanisms (prior and after capital raising)

1. What should be the characteristics of a supervisory board member (age, gender, business experience, etc.)?
2. Which kind of persons do you prefer to have in the supervisory board?
3. What should be the proper size of the supervisory board (the number of members)?
4. In your opinion, what is the role of the supervisory board?
5. Do you have a view, how many times and how frequently the supervisory board should meet?
6. Which are the main tasks for the supervisory board?
7. Should supervisory board focus more on monitoring function or provide help with its expertise?
8. Do you consider board committees necessary for the company? If yes, please name them.
9. Do you prefer 1) concentrated ownership, 2) dispersed ownership, 3) institutional ownership, or 4) managerial ownership concentration in the company? Please explain.
10. How the executives (managers) should be remunerated?
11. What kind of function internal control and audit should have in the company?

RESÜMEE

ETTEVÕTTE SISESTE *CORPORATE GOVERNANCE* MEHCHANISMIDE OOTUSTE MUUTUSED ALGFAASIS OLEVAS JA KAPITALI KAASAVAS ETTEVÕTTES: MILREM AS JUHTUMIUURING

Madis Jääger

Corporate governance on kogum ettevõtte juhtimise mehhanismidest, protsessidest ja suhetest, mille abil toimub ettevõtete kontrollimine ja suunamine. Kogumi eesmärgiks on vähendada tekkivaid huvide konflikte (*conflicts of interest*) ja moraalitu käitumise (*moral hazard*) riski. Valdav osa selle valdkonna teadusuuringutest baseerub arenenud riikide hajutatud aktsionäride struktuuriga ettevõtetel, väiksemaid eraettevõtteid on vähem uuritud.

Autorile teadaolevalt puuduvad varasemad uuringud algfaasis olevate Eesti ettevõtete *corporate governance* mehhanismide muutustest. Käesolev magistritöö soovis seda tühimikku täita.

Üheks keerukuseks magistritöö empiirilise osa uurimisel oli eestikeelselt üheselt arusaadava terminoloogia puudumine mitmete levinud mõistete puhul. Nii kasutatakse valdaval juhul terminit *corporate governance* inglisekeelse väljendina, kuivõrd vähem levinud tõlkena kasutatavad 'ettevõtte haldamine' ja 'ettevõtte valitsemine' omavad eestikeelses kontekstis valdavalt teistlaadi tähendusi. Sellest tulenevalt ei ole autor püüdnud eraldi inglisekeelseid termineid tõlkida juhul kui puudub täpne üheselt arusaadav eestikeelne vaste, sest see võiks põhjustada vaid täiendavat arusaamatust temaatika käsitlemisel.

Magistritöö eesmärk on välja selgitada, kuidas muutuvad organisatsiooni elutsükli algfaasis olevas ettevõttes ootused organisatsioonisisestele *corporate governance* mehhanismidele kui asutajaaktsionäri(dele)/osanikule(ele) kuuluv ettevõtte kaasab omakapitali. Eesmärgi täitmiseks on püstitatud järgmised uurimisülesanded:

- 1) defineerida *corporate governance* mõiste;
- 2) anda teoreetilise ja varasemate uuringute põhjal ülevaade peamistest *corporate governance* valdkonda puudutavatest teooriatest ja sisestest mehhanismidest;
- 3) anda teoreetiliste ja varasemate uuringute põhjal ülevaade ettevõtte elutsükli algfaasis aset leidvatest ootuste muutustest organisatsioonisisestele *corporate governance* mehhanismidele;
- 4) selgitada juhtumiuuringu ettevõttes välja *corporate governance* probleemi põhjus;
- 5) koguda erinevatest allikatest andmeid ja tõendusmaterjale organisatsioonisiseste *corporate governance* mehhanismide ootuste kohta;
- 6) analüüsida kuidas muutuvad organisatsiooni elutsükli stardifaasis olevas ettevõttes ootused organisatsioonisisestele *corporate governance* mehhanismidele kui asutajaaksionärile(dele)/osanikule(ele) kuuluv ettevõtte kaasab omakapitali ning võrrelda seda teoreetilises kirjanduses ja varasemates uuringutes esitatuga.

Corporate governance hõlmab mitmeid olulisi aspekte. Kuivõrd läbiviidud teadusuuringuid ning sellega seonduvaid temaatikaid on analüüsitud lähtudes erinevatest suundadest ja rõhuasetustest, siis esmalt defineeriti *corporate governance* mõiste ning selgitati huvide konflikti ja moraalitu käitumise riski. Teoreetilise raamistiku selgitamiseks kasutati organisatsiooni toimimist selgitavat agenditeooriat, *resource dependence* teooriat ning *stewardship* teooriat.

Töös on selgitatud *corporate governance* mehhanismide eesmärged ning seda kuidas eesmärkidele püüdluse kaudu saab lahendada *corporate governance* probleeme. *Corporate governance* mehhanismid jagunevad ettevõttesisesteks ja -välisteks mehhanismideks. Sisesed mehhanismid on mõjutatavad ettevõtte aktsionäride ja nõukogu poolt, välistele mehhanismidele neil otsene mõju puudub. Ettevõttesiseste *corporate governance* mehhanismidega seotud ootuste muutuseid analüüsiti ettevõtte elutsükli algfaasi kontekstis ning järeldati, et vajadus monitooringu ja ressursside järele on ettevõtte algfaasis muutuv.

Empiiriline uurimistöö põhines ettevõtte Milrem AS juhtumiuuringul. Töö käigus viidi läbi dokumendianalüüs ning sihtrühmaga poolstruktureeritud intervjuud, mille alusel

analüüsi ootuste erinevusi ettevõttesiseste *corporate governance* mehhanismidele ettevõtte algfaasis. Juhtumianalüüs tugines autori poolt koostatud *corporate governance* mudeli raamistikul.

Empiirilise uurimistöö peamised tulemused selgitasid esmalt vajadust määratleda ettevõtte *corporate governance* probleem. Juhtumiettevõttes oli strateegia kujundamise lahkavamate põhjuseks informatsiooni asümmeetria, millest tekkis moraalitu käitumise risk. Magistr töö kontekstis tähendab moraalitu käitumise risk seda kui teatud informatsiooni asümmeetria esinemise korral aktsepteerib juht suuremat riski kui aktsionärid oleksid seda nõus taluma. Moraalitu käitumise tagajärjel on juhil kui otsuse tegijal oluliselt vähem kaotada kui aktsionäridel. Selleks, et selgitada kuidas muutuvad ettevõttesisesed *corporate governance* mehhanismid, keskendus juhtumiuuring eelkõige 1) nõukogu koosseisule, 2) nõukogu rollile ja 3) juhtide tasustamise mehhanismidele. Lisaks analüüsi osaluse suurusel tuleneva mõjuvõimu (*ownership concentration*) muutumist, mis uuringu tulemusena ei kinnitanud selle muutumist. Uuring tõi samuti välja erinevad nägemused nõukogu liikmetele esitatud ootuste osas.

Peamine erinevus asutajaaktsionäri ja uute investorite ootuste vahel oli kontrolli tähtsus juhatuse tegevuse üle. Agenditeooria selgitab seda läbi erinevate ootuste investeeritud raha kasutamise osas. Kui investor investeerib raha ettevõttesse, siis teooria kohaselt on investor printsiipali ning ettevõtte agendi rollis. Sellest tulenevalt tekib investoril vajadus kontrollida ettevõttesse investeeritud raha majandamist.

Erinevad nägemused juhtide tasustamise osas avaldusid aktsiaoptsooniprogrammi ulatuse määratlemisel. Uued investorid eelistasid programmi laiendada vaid ettevõtte võtmeisikutele, suunamaks nende käitumisviise ja huvisid sarnaseks ettevõtte aktsionäridega. Ettevõtte asutaja ja enamusaktsionär pidas vajalikuks kaasata programmi kõik töötajaid viisil, mis tagaks programmis osalejatele aastapremia väärtuse alusel arvestatud aktsiaosaluse. Töötajate huvide suunamist ja ühitamist ettevõtte eesmärkidega saab enamusaktsionäri hinnangul lahendada muul viisil.

Magistr töö omab väärtust vähemalt kolmele sihtrühmale. Esiteks, olles esimene uuring sellel teemal, loob magistr töö teadlastele ja teistele akadeemilise uurimustööde tegijatele aluse ja raamistiku edasisteks uuringuteks selles valdkonnas. Teiseks, analüüs võiks olla

huvipakkuv ettevõtte asutaja(te)le, kes soovivad parandada juhtimisprotsesside ja otsuste kvaliteeti loodavates ettevõtetes. Kolmandaks, magistritöö võimaldab investoritel paremini mõista ettevõtte omanike käitumist ja seisukohti kapitali kaasamise läbirääkimiste käigus ettevõtjatega. Kokkuvõttes suurendab magistritöö teadlikkust ettevõtte juhtimise teemaatikast, mille tulemuseks on paremad juhtimisotsused.

Magistritöös esitatud juhtumiuuringu põhjal saab uurimisvaldkonda laiendada ettevõttesiseste *corporate governance* mehhanismide mõju hindamisele informatsiooni asümmeetria ja moraalitu käitumise probleemide lahendamiseks. Edasised uuringud võiksid hõlmata ka ettevõtteväliste *corporate governance* mehhanismide mõju hindamist, samuti grupeerides sisesed ja välised mehhanismid pakettidesse ning võimaldades hinnata nende mehhanismide asendatavust ning vastastikust täiendavust.

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