



School of Economics and Management  
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**An Evaluation of the Corporate Governance System at  
Smartner Information Systems Ltd -**

*How is the relationship between the CEO and board of  
directors at Smartner Ltd affected by the conflict of  
interest?*

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Advisor: Johan Alvehus

## **Abstract**

**Title:** An Evaluation of the Corporate Governance System at Smartner Information Systems Ltd – *How is the relationship between the CEO and board of directors at Smartner Ltd affected by the conflict of interest?*

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**Abstract:** In order to survive constant economic, environmental and political challenges, it has appeared to become increasingly important for a firm to recognize the significance of corporate governance. In this thesis, the structure of the board at Smartner Ltd will be outlined and the relationship between the board members and the CEO will be clarified. In addition, the aim is to analyze the corporate governance system at Smartner Ltd to be able to outline and clarify the distinct relationship between the CEO and board of directors.

**Methodology:** A qualitative research

**Empirical**

**Foundations:** The sources are primary and secondary. Articles, literature related to the topic and interviews with the board of directors and CEO at Smartner.

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Nathalie Hedman and Inés Ressaissi

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# 1 Introduction

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*The aim of this section is to briefly describe the significance of corporate governance, as well as the function of the board of directors. Thereafter, this will be narrowed down to the problem this thesis aims to examine. Subsequently, the purpose of this research will be illuminated as well as a concise presentation of the chosen company.*

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In the world of today, businesses reside in a dynamic environment which assesses their agility in surviving constant economic, environmental and political challenges. To facilitate the process, it has appeared to become increasingly important for the firm to recognise the significance of corporate governance. In most industrialised countries, a board of directors serves the function as a monitor of the company and top management, mainly acting in the interest of the company's shareholders, while a chief executive officer is appointed to manage the daily operations. The board of directors is lead by the chairman of the board, who sometimes also holds the position as CEO.

However, it may be a difficult task to ensure that management does not deviate from their primary responsibilities, as is continuously illustrated by the numerous cases of corporate scandals. For instance, in 2002 a number of accounting scandals swept through the United States as several companies underwent a series of creative accounting acts to create a misconception of their current corporate status. As a result, the U.S. Securities and Exchange Commission initiated a number of corporate

investigations involving among others Enron, Xerox, WorldCom and AOL.<sup>1</sup>

## **1.1 Problem Discussion**

There are various factors which may explain the *raison d'être* of this apparent difficulty in monitoring top management. As management often report directly to the board of directors, this may result in a discrepancy in the conveyed information if the management seeks to hide certain aspects of the current situation. Also, as some board members possess neither the time nor understanding for the corporate details of the company, management may mask certain problems to the board.<sup>2</sup>

Even if the Board of Directors should act in the interest of the company and its shareholders, they may also find it difficult to confront the strategic actions of powerful CEOs and top management teams. Though the board of directors possess a fiduciary duty to represent the owners, directors sometimes still follow their incentives which may lead them to favour management over the shareholders.

In addition, it is not unusual for the Board of Directors to consist of "inside" directors, an individual with the dual role as an investor and board member. Moreover, some "inside" directors also represent companies owning a substantial stake in the company. In other cases, the board of directors may consist of a number of sympathetic outside board members.<sup>3</sup> A common factor in both of these cases is that the CEO maintains significant control over the board's actions. Strong relationships

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<sup>1</sup> news.bbc.co.uk

<sup>2</sup> Lorsch, 1995

<sup>3</sup> De Andres et al, 2005

between the CEO and the board of directors could therefore have a negative influence on corporate governance.<sup>4</sup>

The problems surrounding the board of directors have only recently gained interest in the academic world, illustrated by the lack of research within the area.<sup>5</sup> The main area of focus that we therefore want to address is the board of directors as a management control mechanism. Specifically, the aim of this paper is to outline and clarify the relationship between the board of directors and CEO at Smartner Ltd.

*How is the relationship between the CEO and board of directors at Smartner Ltd affected by the conflict of interest?*

Nevertheless, to be able to address this issue, we first need to have an adequate background of the company.

### **1.1.1 Smartner Information Systems Ltd**

Smartner Information Systems Ltd is a privately owned company supported by several principal European venture capital investors. Included among the investors are EQVITEC Partners Ltd, IT Provider Adviser 1 AB, Sitra and Amadeus Capital Partners Ltd. Founded in Finland in 1999, Smartner Information Systems Ltd presents operators, enterprises and individuals with leading mobile software solutions. The company has the support of solid investors as well as partners in the areas ranging from the IT and wireless industry to device manufacturers. Smartner is in the process of expanding through to the international

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<sup>4</sup> Ireland et al, 2003

<sup>5</sup> Pettigrew, 2002

business sector and currently has offices in Finland, UK, France, US, Spain and Sweden.<sup>6</sup>

## 1.2 Purpose

In general, countries may fall under either an insider-dominated or outsider-dominated system of corporate governance.<sup>7</sup> Insider-dominated countries exhibit a highly concentrated ownership structure in which the owners thus also maintain a majority of the corporate control. In contrast, outsider-dominated countries such as the U.S. and United Kingdom have a tendency to separate ownership and control.<sup>8</sup> Corporate governance is therefore especially important in insider-dominated countries, which typically lack external monitoring facilities of the management, as the risk of potential conflicts of interest between the board and top management will be higher.

However, as evident by the number of corporate scandals in outsider-dominated countries such as the U.S. and United Kingdom during the past decade, the existence of external monitors such as the FSA and the separation of ownership and control do not always eliminate conflicts of interest between the CEO and Board of Directors.<sup>9</sup> The fact that corporate governance remains problematic to the corporate world therefore indicates that the corporate monitoring system in UK firms may contain flaws.<sup>10</sup>

The purpose of this thesis is thus to analyse the corporate governance system at Smartner Ltd in order to outline and clarify the distinct relationship between the CEO and board of directors.

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<sup>6</sup> [www.smartner.com](http://www.smartner.com)

<sup>7</sup> Jenkinson et al, 1992

<sup>8</sup> Kay et al, 1995

<sup>9</sup> [www.news.bbc.co.uk](http://www.news.bbc.co.uk)

<sup>10</sup> Traversone, 2005



### **1.3 Outline**

This paper is structured as follows. The following chapter involves the selected methodology. It will include topics such as procedure, perspective and research. The next section outlines the adopted theoretical framework. It commences by illustrating a brief summary of OECD's principles of corporate governance. Subsequently, the chosen theoretical models will be outlined. Finally, the structural implications of the board of directors and management will be introduced. In the empirical chapter we will present data collected from both interviews and from articles related to corporate governance. Finally, we will conclude the thesis with an analysis followed by a conclusion which includes our personal reflections upon the results.

## 2 Methodology

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*This section will describe the different methodologies that have been applied in our research. The purpose of this chapter is to explain what procedures were used and why these methods were considered necessary. In doing so, it will thus create a better understanding for the work behind this thesis.*

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### 2.1 Research approach

The methodological approach that we chose for this thesis is of a qualitative character since it is an unstructured, exploratory research with samples which serve to provide a more profound understanding of the problem.

The research includes an examination of individuals in their working milieu at Smartner Ltd. In order to be able to investigate the relationship between the board of directors and CEO, we believe that it is significant to first understand human behaviour. Hence, it is necessary to describe, analyse and understand the behaviour and decisions made by the individuals in their natural environments.<sup>11</sup> By investigating these individuals, with potentially differing opinions, backgrounds and goals, it will thus illuminate the relationship between the CEO and board of directors at Smartner Ltd and how it is affected by a conflict of interest.

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<sup>11</sup> Lundhal et al, 1999

As researchers, we dealt with question marks concerning how people experience different situations, which in this case involved how board members and the CEO experience the communication with each other.

Apart from the qualitative research criteria mentioned earlier, we also wish to apply this approach by effectively utilizing different methods of data collection such as literature research, article research and interviews.

## **2.2 Inductive research**

The research conducted in this thesis follows an inductive pattern. To begin the research process at Smartner, we collected data by interviewing the CEO and three of the board members. We wanted to discover certain aspects of the corporate governance system at Smartner to which we could apply the theories suitable to our research results. Since the research attempts to generate theoretical assumptions on the basis of the data and the research also precedes the theory, it therefore follows more of an inductive approach.<sup>12</sup>

## **2.3 Procedure**

We have chosen to examine the precise relationship between the CEO and Board of Directors at Smartner Information Systems Ltd. Our primary data was obtained by one on one interviews with three board members and the CEO. Our secondary data, on the other hand, was mainly collected from articles and books related to our research topic, found at different libraries.

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<sup>12</sup> May, 1997

### 2.3.1 Primary material

We have chosen to conduct semi-structured interviews, meaning that the interviewees were allowed to respond freely to the interviewer's questions.<sup>13</sup> During the course of the interviews, this gave us the opportunity to have a natural dialogue with the interviewees. Although the interviewees had the freedom to liberally answer the questions, we still used a structured interview guide which all the interviews followed. Since this type of interviews resembles a simple dialogue, we thought this method would make the interviewees feel more comfortable and relaxed during the interviewing process. We also considered that the interviewees would thus be more inclined to share their opinions and experiences.

The people that we interviewed were among others Paul Hedman, who was appointed Chief Executive Officer by Smartner's Board in 2003, which consists of six directors from various backgrounds and countries. The Chairman of the Board is Jukka Norokorpi, an independent advisor specializing in advising ICT companies during internationalization, partnering strategy and processes. Besides Smartner Ltd, he is also a Board Director at HiQ International AB and Friends Technology Oy.<sup>14</sup> Åsa Sundberg is also a member of the Board at Smartner Ltd and a Partner at IT Provider. Andrea Traversone, an Investment Manager at Amadeus Capital Partners, is yet another Board Member.

These interviews have made up an indispensable part of our research, since the obtained data provides an insight into some of the board members' and CEO's points of view on how a board meeting at Smartner operates. The

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<sup>13</sup> May, 1997

<sup>14</sup> [www.smartner.com](http://www.smartner.com)

interviews were accomplished with the help of a Dictaphone, with the purpose of recovering all the information provided by the interviewees. All of the interviews were not conducted with the help of a Dictaphone since some interviews were held over the phone. To be fair to the participants, we gave them the possibility to review the interviews and make any clarifications if necessary.

Another aspect we considered was to hold the interview in the respondent's primary language, since it facilitates the ability to communicate effectively during the interview process. By taking this into consideration, the feeling of speaking a language which the interviewee is less familiar with will not interfere with the interview itself.<sup>15</sup> For instance, when interviewing Åsa Sundberg, a Swedish board member, we carried out the interview in Swedish and then translated it into English. In addition, the same questions were asked to all the interviewees, but naturally adapting the interview questions when addressing the CEO. In doing this, the intent was to see how their experiences and point of views differ from each other more clearly and thus help us reach a conclusion to our problem discussion.

### **2.3.2 Secondary material**

In order to acquire a complete understanding for the structure of the board of directors, board roles and the role of the CEO; different articles related to corporate governance have been studied. Our secondary data has contributed to a solid ground together with our theoretical findings. Most of the articles that have been studied were collected from the article room at the Department of Business Administration Library.

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<sup>15</sup> Bryman, 2003

## **2.4 Criticism to references**

The articles utilized in our research have been examined cautiously and the reliability of the sources confirmed. Most articles were available at the Library at the Business Administration Department, which we consider a trustworthy source of information. Most of the articles that were used relate to the relationship between the CEO and Directors as well as capital markets and corporate monitoring.

Concerning the data gathered from the internet, we examined our findings from a critical point of view and decided to use the data in a more descriptive nature in order to understand different concepts. Some of the articles collected online were also taken from reliable sources such as governmental institutions like the official OECD and SEC websites.

When evaluating internet sources, our main attention was focused on ensuring reliability and credibility, by verifying the author, his or her association, date and the source of publication.

## 2.5 Validity and Reliability

### 2.5.1 Validity

Research should essentially capture the reality of the investigated situation. There are however many factors, such as question composition, interviews and the respondent's sincerity, that are used to create an entirety consistent to reality.<sup>16</sup>

Upon reflecting on the results from the interviews, we recognize that the questions asked may have been stated in a vague manner and that we as interviewers may unintentionally have affected the interviewees with our own values. We were also well aware of the possibility that the interviewees may have been embarrassed to reveal certain details about his/her situation and thus conceal certain information from the interviewer.

### 2.5.2 Reliability

Reliability indicates how reliable the various sources are.<sup>17</sup> A high degree of reliability will ensure that our data is reliable and that it could facilitate the research by illuminating the problem. In order to establish a reliable structure, it is however significant to follow certain criteria. Since we abide by a qualitative research process, we are thus inclined to follow the following criteria:<sup>18</sup>

- Credibility: parallels internal validity, how believable the findings are
- Transferability: if the findings apply to other contexts
- Dependability: if the findings are likely to apply at other times

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<sup>16</sup> Svenning, 1999

<sup>17</sup> ibid

<sup>18</sup> Bryman, 2003

- Conformability: if the investigator allows his or her values to intrude to a high degree

## **2.6 Methodology Discussion**

If we had the possibility to change or compliment our methodology, we would have chosen to conduct participant observations by attending a board meeting at Smartner. Participant observations are one of the most prominent methods in qualitative research, which is often combined with interviews.<sup>19</sup> We would have liked to carry out this method since the advantage of observing a selected situation is an effective way of obtained accurate sample of social reality. As an observer, you are thus subjected to the same experience as the members of the actual social setting. For example, a participant observer may reside in the same environment as a social anthropologist, visiting unfamiliar grounds, with the goal to understand the cultural atmosphere. In order to make the situation less complicated for the observer as well as to gain an accurate view of the social settings and culture, the language in the selected area must be learned. It is not merely enough to know the formal language that needs to be comprehended in order to be able to observe an unfamiliar area.

If this procedure could have been performed, the 'argot' - the specific words and slang would have been studied since they are significant in understanding and penetrating the culture in question. Applying this to our particular situation, it is thus less complicated to reach a high degree of understanding if we hade the possibility to observe the language used during board meetings.

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<sup>19</sup> Bryman, 2003



Although a good deal important information has been obtained through interviews, we still believe that participant observations would have contributed with additional data not captured through the interview process, since interviews depend primarily on verbal behaviour.<sup>20</sup> However, since the board meetings at Smartner involve confidential and sensitive material, a participant observation was unfortunately not an option.

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<sup>20</sup> Bryman, 2003

### 3 Theoretical Background

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*In order to analyse the corporate governance system at Smartner Ltd, the theoretical background will briefly be examined. This section is structured in three parts. To begin with the OECD's principles of corporate governance will be outlined. Thereafter, the theoretical models chosen for this thesis will be introduced. Finally, corporate governance issues such as the size of the board, as well as its composition and structure will briefly be summarised; to understand the board of directors, it is important to clearly define the function and objectives of the board of directors.*

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#### **3.1 The OECD's principles of corporate governance<sup>21</sup>**

The corporate governance system appropriate to a particular country may differ extensively, suggesting that there is no optimal or universal model of corporate governance. However, there are fundamental basics which constitute good corporate governance. The OECD has therefore developed a set of principles of good corporate governance with the aim of reaching a balance between the Anglo-American and Franco-German models of corporate governance. The OECD describes corporate governance as a set of relationships between a company's management, its board, its shareholders and other stakeholders and the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.

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<sup>21</sup> OECD principles of corporate governance 1999

The principles are divided into five chapters, in which the first two concern the rights of the shareholders and the equitable treatment of shareholders and the last two focuses on the board of directors. The third chapter, on the other hand, addresses the company's stakeholders, specifically focusing on the employees. Briefly, the OECD's principles of corporate governance are as follows;

### **I The rights of shareholders**

The corporate governance framework should protect shareholder's rights.

### **II The equitable treatment of shareholders**

The corporate governance framework should ensure the equitable treatment of all Shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

### **III The role of stakeholders in corporate governance**

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound Enterprises.

### **IV Disclosure and transparency**

The corporate governance framework should ensure that timely and accurate information is disclosed on all material matters regarding the financial situation, performance, ownership, and governance of the company.

### **V The role of the board**

The corporate governance framework should ensure strategic guidance and effective monitoring of the company by the board, and the board's accountability to the company and the shareholders.

These principles are designed to support in evaluating and improving the corporate governance system residing in a company and also intend to offer guidance to those involved with corporate governance. The topics covered by the principles are the rights and responsibilities of shareholders, the role of stakeholders, equal treatment of shareholders, disclosure and transparency and the duties and responsibilities of the board. These principles will be utilised as a guide upon evaluating the corporate governance model at Smartner Ltd. However, as this thesis concerns the relationship between the Board of Directors and CEO, the evaluation will focus on the duties and responsibilities of the board.

### **3.2 Theoretical approaches to Corporate Governance**

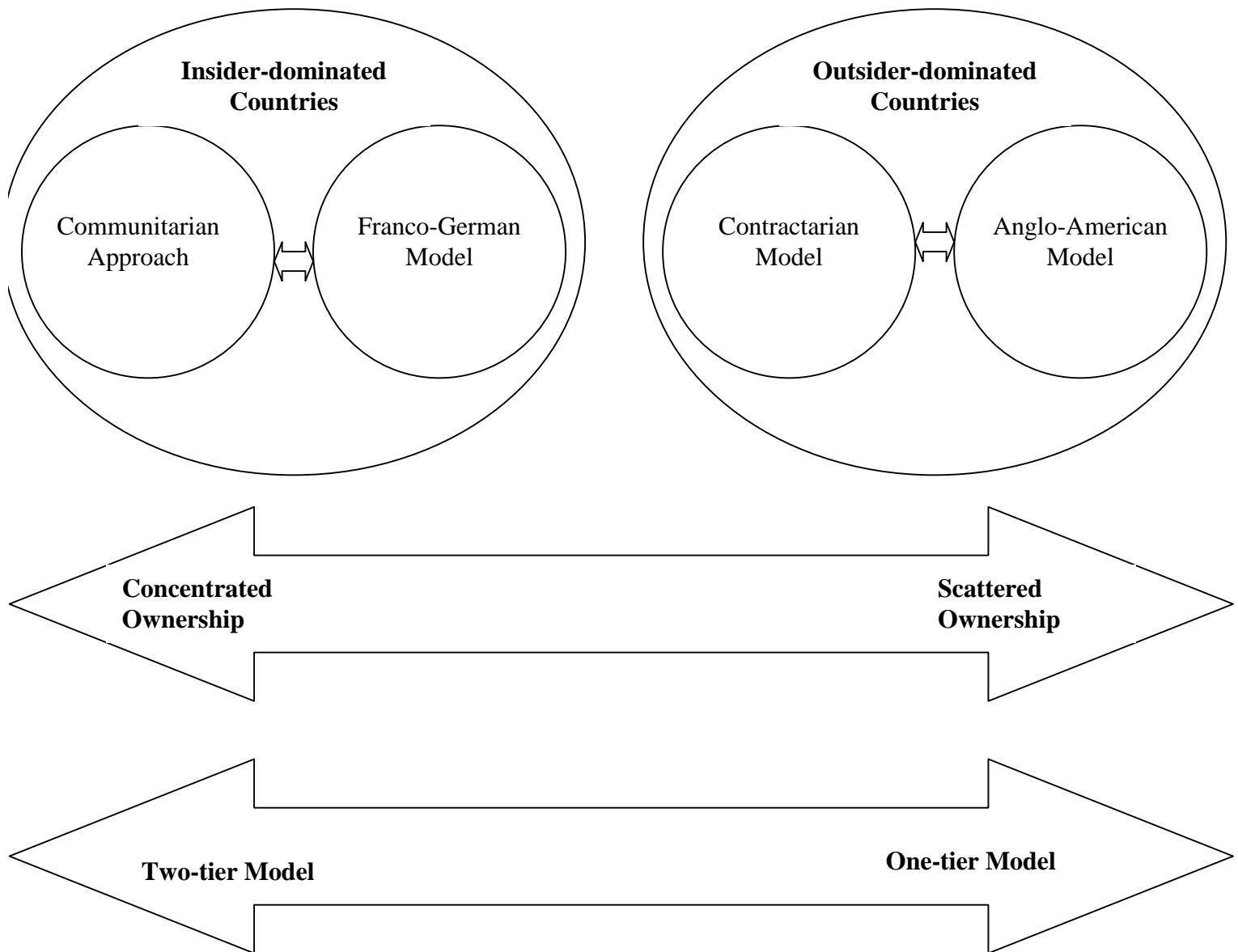
Discrepancies between different theoretical approaches to corporate governance are not solely perceived through the issue of control, they are also reflected in the corporate structure in companies. Corporations in the US and UK for instance, adhere to the one-tier board model by maintaining only one board of directors. In the two-tier model, on the other hand, two boards persist, in which a management board attains the decision management function and the supervisory board is responsible for decision control.<sup>22</sup>

These theoretical models can be paralleled with the Anglo-American and Franco-German models of corporate governance in which the one-tier model often corresponds to the Anglo-American model and the two-tier model to the Franco-German. The Anglo-American or Contractarian model is characterised by a distinct separation of ownership and control, thus

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<sup>22</sup> Maassen, 1999

being classified as an outsider-dominated system. The following model simplifies the relationship between the different concepts.



*Model of Corporate Governance, Hedman, N. 2005*

The insider-dominated system, on the other hand, often describes Japanese and Continental European corporations which typically lack external devices to effectively control management.<sup>23</sup> Banks traditionally assume a significant role in these countries, legally permitted to hold a significant amount of equity in corporations. This perspective of the firm as a social institution often called the Franco-German or communitarian model. In contrast, associated with the Anglo-American or contractarian model is the conviction that the goal of the modern organisation is to maximise shareholder value and endow minority shareholders with security that this occurs.<sup>24</sup>

### **3.2.1 The Contractarian Approach**

The residing Corporate Governance system in the UK can be divided between an internal monitor and a broader regulatory framework within with the companies function.<sup>25</sup> In general, the aim of both external and internal systems of monitoring strategic activity is chiefly to make sure that the company operates efficiently and generates economic activity, whilst reducing agency costs. Arguments involving the optimal structure of corporate governance have drawn various opinions but can loosely be categorized according to two theoretical approaches, contractarian and communitarian.<sup>26</sup>

The contractarian approach posits that contracts are the main instrument through which stakeholders exercise control over the management so as to shield themselves from potential conflicts of interest.<sup>27</sup> The chief notion

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<sup>23</sup> Mak et al, 2001

<sup>24</sup> Slinger et al, 1999

<sup>25</sup> Visentini 1998; Barca, 1997

<sup>26</sup> Jensen et al, 1976

<sup>27</sup> Jensen et al 1976; Gilson, 2001

dominating this approach is that the firm's investors are the only stakeholder group with a residual claim to the company's assets. The ambition here is to maximise shareholder wealth and produce the optimal return on the investment of equity capital. Considering that the investors have a major claim on the company's assets, they are thus the stakeholder with the largest motive to supervise.<sup>28</sup>

### **3.2.2 The Communitarian Approach**

The communitarian approach, on the other hand, infers that corporate monitors should ensure that the firm operates as a responsible societal institution.<sup>29</sup> This approach is intended to guarantee that by creating wealth, the company is responsible for the environment in which it resides and for improving public policy issues such as shareholder and environmental protection, as well as employee standards.<sup>30</sup>

Hence, this theoretical approach regards corporate monitoring as an instrument through which the company and its key management are held responsible towards stakeholders. The main purpose still entails shareholder wealth maximisation, but is alleviated by an idea of corporate social responsibility.

Although the communitarian and contractarian approaches differ, they have both been large contributors to the debate concerning corporate governance. As key officers are solely held liable towards shareholders, Contractarians generally possess a more lenient approach with regards to the officer's liability towards the owners.

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<sup>28</sup> Braithwaite et al, 2000

<sup>29</sup> Dallas, 1996

<sup>30</sup> International Business Law Review, 2000

However, the contractarian approach is unfortunately unable to discriminate between shareholder wealth maximisation and investment timelines. In addition, this results in the generation of a false differentiation between operating costs in the firm that are accounted for within the organisation and those which are not.

The communitarian approach may thus serve as a means to achieve a complete examination as it considers the costs associated with corporate transaction, costs that would otherwise be regarded as an externality by the contractarian approach.<sup>31</sup> However, the lack of ability in expressing who should make the decisions regarding the corporation's priorities gives rise to a model susceptible to a form of decision-making which nobody is accountable for.

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<sup>31</sup> White, 1999



## 3.3 The Board of Directors and Top Management

### 3.3.1 Board Roles

The board of directors may vary significantly between countries but are generally entrusted with three functions. The roles may be divided into service, control and resource dependence. Firstly, boards fulfil the service role by advising management in various managerial issues. Related to the service role is the resource dependence role which considers the board as a way to simplify the firm's attainment of critical resources<sup>32</sup>. This role hence encourages the firm to select directors with significant external connections i.e. outside directors<sup>33</sup>. By providing a gateway to valuable resources and information, facilitating obligations and helping the firm in maintaining a legitimate character, outside directors are advantageous to the company<sup>34</sup>. Finally, in the control role, the board of directors act in the interest of the shareholders by monitoring the management's actions. They are thus chiefly responsible for the hiring and firing of the CEO<sup>35</sup>.

Most criticisms have been directed mainly at the effectiveness of this board role and it has hence become the most crucial function of the board of directors. Being utterly independent from top management, "outside" directors with no personal connection to the firm are believed to excel within this role. Inside directors, however, are less likely to serve as an effective monitor of the management on account of their internal position in the firm; conflicts of interest are possible to the extent that the inside director will attempt to avoid these conflicts in order to maintain a loyal

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<sup>32</sup> Johnson et al, 1996

<sup>33</sup> Pfeffer et al, 1978; Selznik, 1949

<sup>34</sup> Bazerman et al, 1983; Pfeffer et al, 1978; Provan, 1980

<sup>35</sup> Johnson et al, 1996

character towards the CEO, thus deliberately introducing a high degree of subjectivity in evaluating the management<sup>36</sup>.

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<sup>36</sup> Dalton et al, 1989

### 3.3.2 Board Structure

#### Board Size

It is often disputed whether board size has a significant effect on the board of director's ability to effectively monitor management. Research has illustrated that a small board in combination with a large proportion of outside directors results in a board of directors with a high degree of participation within the formulation of new strategies<sup>37</sup>. In addition, a larger board has the ability to contribute with a wider range of experiences and opinions<sup>38</sup>. As it is more difficult for a CEO to dominate a large board, larger boards are also more able to monitor management<sup>39</sup>. In some cases, the agility of the board in supervising management can increase as the number of board members increase. However, the benefits must be weighed against the by costs in terms of the poorer communication and decision-making associated with larger boards.<sup>40</sup>

Eisenberg et al, on the other hand, inferred that there are several disadvantages with large boards. This includes poorer communication and decision-making<sup>41</sup>, decreased capability in controlling the management<sup>42</sup> and a longer time span in making decisions<sup>43</sup>. In addition, there is also evidence suggesting that a smaller number of directors are more efficient and that their companies attain higher market value. Previously, financial markets have proven to react positively to board downsizing, while a

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<sup>37</sup> Fried et al, 1998

<sup>38</sup> Xie et al, 2003

<sup>39</sup> Mak et al, 2000

<sup>40</sup> De Andres et al, 2005

<sup>41</sup> John et al, 1998

<sup>42</sup> Eisenberg et al, 1998

<sup>43</sup> Dehaene et al, 2001

higher number of directors frequently reduce equity value. The larger the board, the smaller the negative effect would be on an additional director.<sup>44</sup>

### Board Composition

The members of the board are usually divided into two types of directors; insiders, those who are both managers and directors at the same time, and Outsiders, who are non-manager directors, since they different incentives and behaviour.<sup>45</sup>

The CEO may play an important role in determining the composition of the board, in cases like bringing together a board that is implausible to challenge his or her power and authority. If the majority of the board consists of outsiders, then the CEO might have to work harder to persuade the directors to adopt their point of view. If the board would consist of mostly insiders, it could be easier for the CEO to control a certain situation. If the CEO would be more interested in strengthening his or her power base rather than constructing a representative board, the CEO might elect a small board with few outside directors and little minority of female representation.<sup>46</sup>

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<sup>44</sup> De Andres et al, 2005

<sup>45</sup> *ibid*

<sup>46</sup> Daily, 1993

## 4 Analysis

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*In this section the relationship between the CEO and Board of Directors at Smartner Ltd will be analysed according to the contractarian or Anglo-American model of corporate governance. The corporate system at Smartner Ltd will be analysed against the principles developed by the OECD.*

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### 4.1 The Corporate Governance System at Smartner

Despite the general classification of countries according to the Anglo-American and Franco-German model of corporate governance, the corporate system between firms in a country may differ.<sup>47</sup> In the words of Andrea Traversone, a director at Smartner Ltd, “The corporate governance system of firms in the UK, a country abiding by the Anglo-American model of corporate governance, may differ due to the adhering corporate culture, individual values and traditions.”<sup>48</sup>

By analysing the corporate system according to OECD’s principles of corporate governance, aspects of the corporate system at Smartner relevant to the problem discussion intend to be clarified. This will however mainly be centred on the final principle, involving the duties and responsibilities of the board. In accordance with the OECD principles, the board have the primary responsibilities as monitors of managerial performance and avoiding conflicts of interest.<sup>49</sup> “To avoid conflicts of interest between the board and CEO, the board must maintain a certain degree of

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<sup>47</sup> Slinger et al, 1999

<sup>48</sup> Traversone, 2005

<sup>49</sup> OECD principles of corporate governance, 2005

independence. At Smartner, this is done by having a non-executive chairman like Jukka Norokorpi, which is normally the case in approximately 75% of UK boards.”<sup>50</sup>

At Smartner, the board of directors consists of five “inside” directors and one “outside” director or non-executive chairman. According to Dalton et al, “outside” directors such as Norokorpi, with no personal connection to the company are believed to excel.<sup>51</sup> On the other hand, due to their internal position in the firm, “inside” directors are not as likely to effectively monitor management. To avoid a conflict of interest and maintain a loyal character towards the CEO, the “inside” directors may thus introduce a high degree of subjectivity.<sup>52</sup>

Most of the information recovered from the interviews support the fact that conflicts of interest are possible to the extent that the inside directors will attempt to avoid conflicts in order to maintain a loyal character towards the CEO. This deliberately introduces a higher degree of subjectivity in evaluating the management.<sup>53</sup> “The CEO is a person I knew from before he was hired at Smartner. I was the one who recommended him to the board, to become Smartner’s CEO. Since I was the one who recommended him, most of the pressure is on me, I have to be more involved in discussions,” says Sundberg.<sup>54</sup>

The other board members that were interviewed also seem to have a very loyal character towards the CEO, since the board came from a business that was going really badly. “When Paul Hedman first started as CEO at

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<sup>50</sup> Traversone, 2005

<sup>51</sup> Dalton et al, 1989

<sup>52</sup> *ibid*

<sup>53</sup> *ibid*

<sup>54</sup> Sundberg, 2005

Smartner, the company was falling and he managed to get Smartner back on its feet,” says Sundberg.<sup>55</sup> “It took some time, but I was conservative with a 300% forecast and managed to raise the profits by 2000% in the first year. In my opinion, it is a mixture of luck and good management,” said Paul Hedman.<sup>56</sup> The Directors also believe that the CEO, Paul Hedman, has such a long history of international experience, so they see no reason to tell him what to do.<sup>57</sup>

Although boards in the UK are monitored by the government department, the role as director is still challenging. Trained to identify and manage conflicts within the board and eventual conflicts with the CEO, Norokorpi holds a key role.<sup>58</sup> However, the full responsibility does not solely lie with Norokorpi. The other “inside” directors are also skilled in avoiding conflicts related to their dual role as an investor and board member. As Traversone mentioned, “During the board meetings, the directors often state whether they are in fact speaking as a board member or as an investor.”

Other times, there have been situations at Smartner in which the directors realise that they are not able to separate their roles as investor and board member.<sup>59</sup> “In 2004, Smartner went through a refinancing stage. As I realised that it would be difficult for me to remain objective, I brought in two colleagues from Amadeus that were totally independent from Smartner to make the decisions.”<sup>60</sup>

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<sup>55</sup> Sundberg, 2005

<sup>56</sup> Hedman, 2005

<sup>57</sup> Norokorpi, Traversone, Sundberg & Hedman, 2005

<sup>58</sup> Traversone, 2005

<sup>59</sup> *ibid*

<sup>60</sup> *ibid*

According to Jukka Norokorpi and Andrea Traversone, it is the CEO who more or less runs the board meetings. CEO Hedman says, "I am responsible for the results. If it goes to hell, I go to hell. I also run the board meetings and have most of the influence; mostly, Andrea is the only active member."

Some of the board members feel that they have a good relationship with the CEO, and they see him as a friend as well as a co-worker.<sup>61</sup> Åsa Sundberg quotes, "My relationship to him is professional but he is also like a friend" The CEO, on the other hand, views the relationship differently; "It is professional, dinner a few times, pretty straight forward."<sup>62</sup>

There are several disadvantages with large boards. This includes poorer communication and decision-making.<sup>63</sup> The fact that Smartner has a relatively small Board of Directors is an advantage for the CEO, who believes that decisions are made faster and easier due to the small size. <sup>64</sup> In addition, it is often more difficult for the CEO to dominate a large board. Larger boards are also more able to monitor the management.<sup>65</sup> CEO Hedman says, "The disadvantage with a large board is that it often takes them a longer time to reach a decision."<sup>66</sup> However, according to Åsa Sundberg, "One problem is when you have a lot of different investors; everyone wants the mandate to decide". This is especially the case at Smartner Ltd since all the directors but Jukka Norokorpi represents venture capital investors.<sup>67</sup>

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<sup>61</sup> Sundberg, 2005

<sup>62</sup> Hedman, 2005

<sup>63</sup> Eisenberg et al, 1998

<sup>64</sup> Hedman, 2005

<sup>65</sup> Mak et al, 2005

<sup>66</sup> Hedman, 2005

<sup>67</sup> [www.smartner.com](http://www.smartner.com)



## 5 Conclusion

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*This section will include our own personal reflections upon the empirical evidence and theories. The intention is to clarify the relationship between the board of directors and CEO at Smartner Ltd and thus provide an answer to the focal question.*

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Being an indispensable part of corporate governance, we found it interesting to study the board of directors in monitoring a firm's strategic actions. As mentioned previously, the aim of this paper was thus to outline and clarify the relationship between the board of directors and the CEO. *How is the relationship between the CEO and board of directors at Smartner Ltd affected by the conflict of interest?*

After conducting interviews, the gathered information illustrated a tendency for the CEO to dominate the board meetings and we therefore got the impression that the CEO usually has most of the influence during board meetings. One of the reasons for this, we believe, is that when Hedman first acquired the role as CEO at Smartner, the company was deteriorating and yet he managed to get Smartner back on its feet. As evident from the interviews with Smartner's chairman, the board members appear to trust him in planning and monitoring the strategic actions of the company. Therefore, they give him a large degree of control and the freedom to make any necessary decisions.

This was not the case with the previous CEO, who did not possess the necessary experience to introduce Smartner to the international market. He thus required constant supervision and aid in making the right decisions.

Hedman, on the other hand, has so much international experience that it is not as necessary to tell him what to do. If a board member reasons like this, then the risk for a conflict of interest between the CEO and Board of Directors will therefore be much smaller.

There are several other aspects to consider upon evaluating the corporate monitoring at Smartner. Firstly, CEO Paul Hedman is always very careful not to be overly optimistic when presenting forecasts to the Board. Because the board expects the forecasted targets to be met, we believe that this strengthens the trust for the CEO as the board gets overwhelmed when the results are better. Another thing to consider is that since Smartner has a relatively small Board of Directors; it is easier for the CEO to dominate a smaller board. However, the board members are inclined to support and help the CEO in most cases.

Some of the directors at Smartner have a personal relationship to the CEO and regard him as a friend as well as a co-worker. We believe that this certainly affects the decisions made by the board; not only did the CEO save the directors investments in Smartner by raising the annual profits by 2000%, but he is also a friend and can therefore be trusted in decision making. In contrast, the CEO himself views the relationship to the board as professional and straight-forward, including occasional dinners, indicating a good relationship.

Several board members were asked whether it is difficult to confront the strategic actions of the CEO. However, they did not experience any difficulties in this area mainly due to the expertise of the Chairman, who is also an "outside" director with no personal investment in the company. The Chairman of the board is trained within corporate monitoring and also

prepared to confront the strategic actions of the CEO, ensuring that difficulties do not arise between the board and the CEO.

The relationship between the CEO and board of directors at Smartner Ltd does not necessarily lead to a conflict of interest for two reasons. To begin with the directors that we interviewed seem to possess a loyal character towards the CEO, since they trust his judgment. As mentioned earlier, this is because the CEO's vast international experience and achievement in reviving Smartner. Another reason is that one of the directors recommended Hedman as CEO and she therefore feels that there is an immense pressure for him to perform well, thus increasing her loyalty towards the CEO. However, being loyal to this extent is not always advantageous as the disadvantage with this type of loyalty, by not being able to share their real opinions, is that it may affect their function as directors.

On the other hand, the conflicts of interest more prone to occur at Smartner are those related to the different backgrounds and experiences of the management team. Another problem that may occur is the conflict of interest related to having both role as investor and a director, which certainly influences decisions and may result in a conflict of interest. This particular situation was experienced by Traversone. In 2004, Smartner went through a refinancing stage and he felt that he was unable to make the right decision independently of his own investment in the company. The solutions to this was thus to bring in two colleagues from Amadeus Capital Partners, who worked independently of Smartner to make the right decisions. Yet the structure of the board, consisting of a majority of "inside" directors, may once again result in a similar opportunities conflict of interest.

Corporate governance is a difficult to evaluate as there are so many factors which may interrelate to cause conflicts in the corporate world. However, by exercising caution in selecting the appropriate executive management and board of directors, a company is able to reduce the extent to which the relationship between the CEO and board of directors is affected by the conflicts of interest. In addition, the integrity, ambitions and experiences of each individual director and officer will contribute to the adhering corporate governance system.

## **Appendix 1 - Interview questions to the Board**

1. Please describe your background.
2. How often do you meet?
3. What are your main functions as a board member?
4. You are a relatively small board of directors. What do you believe are the chief advantages with this structure? Disadvantages?
5. Please define your relationship with Smartner's CEO.
6. Have you ever found yourself in a situation in which you felt that your relationship to the CEO affected your judgement as a board member?
7. As evident by the number of corporate scandals in the U.S. and United Kingdom during the past decade, the existence of an external monitor does not always eliminate conflicts of interest between the CEO and Board of Directors. Why do you think that this is the case?
8. Most criticisms have been directed mainly at the effectiveness of the board in monitoring management. Being utterly independent from top management, "outside" directors with no personal connection to the firm are believed to excel within this role. What are your opinions about this?
9. What can the board of directors do to ensure that the CEO's interests are aligned with the owners?

10. As your role to act in the interest of the company, do you occasionally find it difficult to confront the strategic actions of the CEO and top management teams?

11. Have you experienced a conflict of interest between the board of directors and the CEO?

## **Appendix 2 Interview questions to the CEO**

1. Please describe your background
2. How often do you meet the board?
3. What is your function as CEO?
4. You are a relatively small board of directors. What do you believe are the chief advantages with this structure? Disadvantages?
5. Please define your relationship with Smartner's Board of Directors
6. Have you ever found yourself in a situation in which you felt that your relationship to the board affected your judgement?
7. As evident by the number of corporate scandals in the U.S. and United Kingdom during the past decade, the existence of an external monitor does not always eliminate conflicts of interest between the CEO and Board of Directors. Why do you think that this is the case?
8. Most criticisms have been directed mainly at the effectiveness of the board in monitoring management. Being utterly independent from top management, "outside" directors with no personal connection to the firm are believed to excel within this role. What are your opinions about this?
9. What can the board of directors do to ensure that the CEO's interests are aligned with the owners?
10. As your role to act in the interest of the company, do you occasionally find it difficult to confront the strategic actions of the CEO and top management teams?

11. Have you experienced a conflict of interest between the board of directors and the CEO?



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